

# **ANALYST AND BROKER-DEALER LIABILITY UNDER 10(B) FOR BIASED STOCK RECOMMENDATIONS**

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## **ABSTRACT**

### **Olazábal, Ann M.: ANALYST AND BROKER LIABILITY UNDER 10(B) FOR BIASED STOCK RESEARCH AND RECOMMENDATIONS**

In the aftermath of recent Wall Street scandals, class action suits have been brought by thousands of investors against securities analysts and their broker-dealer employers, based upon stock research and recommendations that were allegedly biased by such conflicts of interest as analysts' ownership interest in researched stocks or other relationships between analysts and issuers, and the fact analysts' compensation was tied to their ability to generate investment banking business from issuers. This work exhaustively analyzes federal 10(b) liability for misleading representations and omissions in this context, through the prism of existing general securities fraud precedent, scant existing authority in cases involving communications by analysts and other non-issuers, and the initial district court opinions that have been generated by pending suits. The author identifies the best arguments in support of and against analyst liability in the case of tainted research, opining that reliance and loss causation will serve as the biggest battlegrounds for the ongoing litigation, and ultimately concluding that in many of the pending cases the alleged facts will suffice to make a prima facie case for jury consideration.

The “fundamental purpose . . . [of the federal securities laws is] to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.”<sup>1</sup>

Since the Great Crash of 1929, the stock market has been the stuff of legends and colorful monikers. The Sixties were the “Go-Go Years”;<sup>2</sup> they were followed by the Seventies’ “May Day” brokerage commission deregulation.<sup>3</sup> October 1997 brought “Black Monday,” when the Dow fell 23% in one day.<sup>4</sup> In the film *Wall Street*, which portrayed high finance in the Reagan era, fictional corporate raider Gordon Gecko famously uttered the me-decade’s credo: “Greed is good.”<sup>5</sup> That bull market continued, in fits and starts, until the turn of the millennium – the years 1999-2000 – and what now may be called the era “Before Spitzer.”<sup>6</sup> It was in those days that CNBC and the Financial News Network were born, the day trading phenomenon emerged, and the most recent unsavory view of Wall Street’s underbelly had not yet been exposed.<sup>7</sup>

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<sup>1</sup> SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963). Despite this prescription, one U.S. District Court Judge has taken the position in the group of cases before him that it is not the role of the law to “punish breaches of business ethics” in a securities fraud case involving allegedly undisclosed research analyst bias. In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig., 289 F. Supp.2d 416, 418 (S.D.N.Y. 2003).

<sup>2</sup> JOHN BROOKS, *THE GO-GO YEARS* (John Wiley & Sons, Inc. 1973).

<sup>3</sup> See ALEX BERENSON, *THE NUMBER: HOW THE DRIVE FOR QUARTERLY EARNINGS CORRUPTED WALL STREET AND CORPORATE AMERICA*, 65-67 (Random House, 2003).

<sup>4</sup> *Id.* at 78.

<sup>5</sup> *WALL STREET* (Twentieth Century Fox, 1987).

<sup>6</sup> Patrick McGeehan, *The Women of Wall Street Get Their Day in Court*, N.Y. TIMES (July 11, 2004) at Section 3, Sunday Business, Page 1 (discussing days before recent Wall Street scandals prompted by New York Attorney General Eliot Spitzer’s investigations, when large scale gender discrimination claims against major brokerage houses were brewing).

<sup>7</sup> Wall Street has been roiled by numerous scandals over the last two years. See, e.g., Ann Davis, *Wall Street Firms Face Scrutiny Over Hedge Funds*, WALL ST. J. (July 22, 2004), at A1 (describing NASD and SEC investigations into conflicts of interest in marketing hedge funds); Susan Pulliam, *“Pipe” Stock Deals are Reviewed*, WALL ST. J. (July 8, 2004), at C1 (reporting on SEC’s inquiry into hedge funds’ alleged use of inside information to profit ahead of “private investment in public equity” deals at expense of other investors); Aaron Lucchetti, *Price Markups Get NASD Scrutiny*, WALL ST. J. (June 18, 2004), at C4 (detailing 20 separate investigations into whether brokerages charged excessive markups on investors’ transactions in corporate and municipal bonds); Ann Davis, *NASD Scrutinizes Conflicts in Bankers’*

Before Spitzer, Wall Street was rife with conflicts of interest percolating just below the surface. Of these, perhaps the biggest was the conflict posed by big brokerage houses' investment banking divisions influencing, or even driving, analysts' recommendations and ratings, which theretofore had been dictated by independent stock research and personal judgment. Many analysts and their broker-dealer employers were too cozy with issuers, often allowing them to preview and revise research reports before they were made public. Investment banking deals were handed to the firm that could deliver the most convincing ratings from its research department. Powerful, so-called "media darling" analysts' astronomical paychecks turn out to have been tied to their ability to generate lucrative investment banking deals. Analysts, bank executives, and often the banks' proprietary trading funds owned stocks the firms publicly pushed, allowing them to profit and profit well from the price inflation that accompanied their consistently bullish Strong Buy and Market Outperform recommendations. Even the rating system itself was suspect; almost no covered stock was given a "sell" or even "neutral" rating.<sup>8</sup> Savvy institutional investors may have taken analysts' stock

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*'Fairness Opinions,'* WALL ST. J. (June 11, 2004), at A1 (discussing investigation into financial incentives of bankers and company executives in pushing through mergers and acquisitions); Deborah Solomon, *SEC Blasts Big Board Oversight of 'Specialist' Trading Firms*, WALL ST. J. (November 3, 2003), at A1 (reporting on two related conflicts of interest: market specialists' trading ahead of investors to the tune of \$128 million in profits for their own accounts and interpositioning that cost investors another \$27 million, and the NYSE's lax discipline thereof, perhaps due to its regulatory arm's own conflicts of interest in prosecuting violations); Jonathan D. Glater, *First Wave of Suits Hits Mutual Fund Companies*, N.Y. TIMES, (September 24, 2003), at C1 (describing investor class action suits arising out of New York Attorney General Eliot Spitzer's investigation into market timing and after hours trading at mutual funds, which preferred certain institutional investors over individuals); Randall Smith, *New Inquiries Are Targeting IPO 'Spinning'*, WALL ST. J. (June 30, 2003), at C1 (portraying practice of "spinning," or selective allocation by investment banks of lucrative new shares to other issuer executives, as latest regulatory scandal facing Wall Street); Jeanne Cummings, *Rapid Exit: SEC's Pitt Resigns Amid Controversy Over Webster Job*, WALL ST. J. (November 6, 2002), at A1 (reporting on uproar over Harvey Pitt's appointment of William Webster to the public accounting oversight board with knowledge of suspected accounting fraud at U.S. Technologies, where Webster had served as head of the audit committee).

<sup>8</sup> See Ann Morales Olazábal and Thomas R. Robinson, *Securities Analysts and "Tainted" Research: What Regulations and Professional Standards Apply?* 1B US L. BRIEF 32 (Spring 2004) (describing tainted

recommendations with the proverbial grain of salt, but for the most part small investors were woefully unaware of the now-obvious conflicts of interest inherent in these supposedly independent stock recommendations and research.<sup>9</sup>

Of course, as history goes, all that came to a grinding halt when the bubble burst and the popular media and Spitzer finally got a handle on the extent of the scheme.<sup>10</sup> After telling email evidence<sup>11</sup> appeared to reveal that some analysts' publicly stated opinions did not reflect their unbiased personal judgments regarding the stocks being touted by their firms, enforcement actions were filed,<sup>12</sup> and a \$1.4 billion "global" settlement was reached between federal and state regulators and ten of the largest broker dealers, purporting to reform investment practices.<sup>13</sup> In addition to assessing fines and investor restitution payments, the settlement severed links between investment banking and analysts (including compensation related ties), banned "spinning" of IPOs, required

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research scandal in detail). For a particularly cynical description of the analyst bias phenomenon, *see* ARIANNA HUFFINGTON, PIGS AT THE TROUGH 154-168 (2003).

<sup>9</sup> Former Chair of the Securities and Exchange Commission, Arthur Levitt, recounts his unsuccessful attempts to get the media to assist in getting the message across to small investors across the country, who apparently were enthralled by analysts' televised recommendations and unfamiliar with the serious conflicts of interest involved in some of their recommendations. ARTHUR LEVITT, TAKE ON THE STREET 70-77 (2002).

<sup>10</sup> An early widely-read magazine questioned Wall Street research's objectivity in the Internet sector, as part of a feature styled "dot.com Ethics." Erick Schonfeld, *The High Price of Research*, FORTUNE (March 20, 2000), at 118. Noted financial reporter Gretchen Morgenson sounded the alarm on the eve of the millennium. Gretchen Morgenson, *How Did So Many Get it So Wrong?* N. Y. TIMES (December 31, 2000), at Section 3, page 1. Eliot Spitzer's renowned investigation into analyst bias began with Merrill Lynch, and resulted not only into publication on the Internet of the Dinallo Affidavit, detailing analysts' and firms' misconduct, a but also a stream of similar investigations by other attorneys general and federal and industry regulators. John Cassidy, *The Investigation; How Eliot Spitzer Humbled Wall Street*, THE NEW YORKER (April 7, 2003). The Dinallo Affidavit – which was attached to Spitzer's office's application for an *ex parte* order under New York's Martin Act permitting the Attorney General to launch a public investigation of Merrill Lynch, with public hearings, and public disclosure of documents – is available at <http://www.news.findlaw.com/hdocs/docs/merrilllynch/nyagmerrill0402aff.pdf>

<sup>11</sup> Dinallo affidavit, *supra* note n-1.

<sup>12</sup> Investors' attempt to intervene or to file amicus briefs in this litigation was unsuccessful. SEC v. Bear, Stearns & Co. Inc., et al., 03 Civ. 2937 (WHP) etc., 2003 U.S. Dist. LEXIS 14611 (S.D.N.Y. August 25, 2003).

<sup>13</sup> Press Release, Securities & Exchange Commission, SEC, NY Attorney General, NASD, NSAA, NYSE and State Regulators Announce Historic Agreement to Reform Investment Practices (December 20, 2002) available at <http://www.sec.gov/news/press/2002-179.htm> (Last modified December 20, 2002).

firms to fund independent research for five years, and mandated public disclosure of all analysts' recommendations, ratings, and price targets.<sup>14</sup> Participants generally heralded the settlement as "the dawn of a new day on Wall Street."<sup>15</sup> Subsequently, NASD and NYSE rules were amended, and the Sarbanes-Oxley Act<sup>16</sup> resulted in new rules and statutes seeking to eliminate some of the specific practices that resulted in so called "tainted" research.<sup>17</sup> With the question of civil liability to investors as yet unaddressed, the private lawsuits had already begun to be filed.

This paper addresses analysts' and their employing broker-dealer firms' liability for securities fraud under Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5,<sup>18</sup> arising out of so-called "tainted" research reports and stock recommendations<sup>19</sup>

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<sup>14</sup> *Id.*

<sup>15</sup> *Id.*, quoting Chris Bruenn, president of the North American Securities Administrators Association. Cf. Gina N. Scianni, Note, *From Behind the Corporate Veil: The Outing of Wwall Street's Investment Banking Scandals – Why Recent Regulations Might not Mean the Dawn of a New Day*, 9 FORDHAM J. CORP. FIN LAW 257 (2003).

<sup>16</sup> Public Company Accounting and Investor Protection Act of 2002 (popularly known as the "Sarbanes Oxley Act of 2002"), Pub. L. 107-204, Title VIII, 116 Stat. 745, 801, codified in scattered parts of 28 U.S.C., was signed into law by President George W. Bush on July 30, 2002.

<sup>17</sup> Olazábal and Robinson, *supra* note \*.

<sup>18</sup> Codified at 15 U.S.C. § 78j(b) and 17 C.F.R. 240.10b-5, respectively. The U.S. Supreme Court has stated that "the scope of Rule 10b-5 is coextensive with the coverage of § 10(b)," citing *United States v. O'Hagan*, 521 U.S. 642, 651(1997) and *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), and therefore, the Court itself adopts the use of "§ 10(b) to refer to both the statutory provision and the Rule." S.E.C. v. Zandford, 535 U.S. 813, 816 n.1 (2002). This Article follows suit.

<sup>19</sup> A number of noted practitioners and scholars in the field have introduced the subject, but none has yet plumbed its depths or considered preliminary rulings in the cases. See John C. Coffee, Jr., *Security Analyst Litigation*, N.Y.L.J. (September 20, 2001), Corporate Update Section at 5; Richard A. Rosen, *Liability for Optimistic Research Reports Prepared by Securities Analysts*, 16 INSIGHTS 9 (April 2002); Jacob H. Zamansky, *Assessing Analysts' Liability for Securities Fraud*, N.Y.L.J. (January 3, 2002) Outside Counsel section at 1; Stanley S. Arkin, *Analysts' Conflicts of Interest: Where's the Crime?* N.Y.L.J. (February 14, 2002), Business Crime section at 3. See also Jill I. Gross, *Securities Analysts' Undisclosed Conflicts of Interest: Unfair Dealing or Securities Fraud?* 2002 COLUM. BUS. L. REV. 631. The subject has also spawned some interest among law students. See Karen Contoudis, Note, *Analyst Conflicts of Interests: Are the NASD and NYSE Rules Enough?* 8 FORDHAM J. CORP. FIN LAW 123 (2003); Robert P. Sieland, Note, *Caveat Emptor! After All the Regulatory Hoopla, Analysts Remain Conflicted on Wall Street*, 2003 U. ILL. L. REV. 531; Kelly S. Sullivan, Comment, *Serving Two Masters: Securities Analyst Liability and Regulation in the Face of Pervasive Conflicts of Interest*, 70 UMKC L. REV. 415 (Winter 2001); Jaimee L. Campbell, Comment, *Analyst Liability and the Internet Bubble: the Morgan Stanley/Mary Meeker Cases*, 7 FORDHAM J. CORP. FIN LAW 265 (2001).

published during the stock market bubble that existed at the turn of the millennium.<sup>20</sup>

The private class action suits brought in attempt to redress this perceived systematic conflict of interest, broadly speaking, have been referred to as “analyst bias” cases.<sup>21</sup>

The pending analyst bias suits are naturally many and varied both substantively and procedurally, depending on such critical details as when the plaintiffs sued, which defendants and which stocks were involved, what level of knowledge the analyst may have had about the actual state of affairs of the given issuer and what type of relationship he or she may have had with the issuer, whether the analyst and/or broker-dealer had an ownership position in the stock covered, what evidence there was of the research-investment banking conflict of interest at the relevant brokerage and what publicity it received in the media and when, whether the analyst or broker-dealer obviously profited from the optimistic recommendations by way of sales of ownership interests in the recommended stock, whether the plaintiffs obtained access to internal emails or other communications revealing the “falsity” of an analyst’s publicly rendered opinions (either before or after filing suit), whether the publicly disseminated email evidence treated the stocks of which plaintiffs complained, and so on.

No easy or general conclusion can be drawn about whether the broad group of fact scenarios loosely headed “analyst bias” may give rise to 10(b) liability. Instead, each

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<sup>20</sup> Many books have already been written about this most recent market bubble, *e.g.*, JOHN CASSIDY, *DOT.CON: HOW AMERICA LOST ITS MIND AND ITS MONEY IN THE INTERNET ERA* (2003); KEVIN HASSETT, *BUBBLEOLOGY* (2002); ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* (2000), including numerous memoirs from various perspectives. *See, e.g.*, DAVID DENBY, *AMERICAN SUCKER* (2004)(investor); J. DAVID KUO, *DOT.BOMB: MY DAYS AND NIGHTS AT AN INTERNET GOLIATH* (2001) (executive at infamous e-tailer Value America); MICHAEL WOLFF, *BURN RATE* (1999) (Internet entrepreneur). Denby, an accomplished writer and journalist reflects on being caught up in the frenzy, notably detailing conversations with Merrill Lynch “superstar” analyst Henry Blodget and various tech stock “gurus” throughout the bubble period and after.

<sup>21</sup> *See, e.g.*, Dennis J. Block and Jonathan M. Hoff, *Mergers and Acquisitions: SLUSA Preclusion of Claims Against Brokers*, 227 N.Y.L.J. 5 (April 25, 2002).

case necessarily involves *ad hoc* examination of its facts and analysis – through the lenses of the common law of 10(b) law, the heightened pleading standards of the Private Securities Litigation Reform Act, and federal class action jurisprudence – to ascertain whether the given suit should survive dismissal, should be certified as a class, and ultimately should go to a jury for determination. There is scant case law directly on point; the pre-existing general case law addressing 10(b) may raise more questions than it answers in this context. This is because this particular system-wide conflict of interest and its unique juxtaposition on a bubble market and securities analysts’ unusually widespread visibility together create a situation that could not possibly have been contemplated by the drafters of the federal securities laws or the courts that have since implied the 10(b) cause of action and explored its contours in different fact settings over the years.<sup>22</sup>

A good place to start is with the basic elements of the claim. To state a cause of action under §10(b), a plaintiff must show that “the defendant, in connection with the purchase or sale of securities, made a materially false statement or omitted a material fact, with scienter, and that plaintiff’s reliance on defendant’s action caused [plaintiff]

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<sup>22</sup> Not so long ago, judges may have been predisposed to make assumptions about the role of analysts in the financial markets that may not have held up during the recent bubble economy. For example, the Second Circuit in 1993 had the following to say about analysts: “... the function of financial reporters and security analysts is to determine the truth about the affairs of publicly traded companies. Few reporters or analysts would knowingly abet a fraud, and many will detect and reveal a corporation’s efforts to use them as a channel for fraudulent statements.” *In re Time Warner Sec. Litig.*, 9 F.3d 259, 265 (2d Cir. 1993). Similarly, in 1992 a California district judge remarked, apparently as a matter of common knowledge, that an analyst will be more objective than a corporate officer in making predictions about issuers’ future performance, and so, more inclined to publish accurate research because “the analyst’s reputation and livelihood depend solely on the analyst’s ability to be correct.” *In re Verifone Sec. Litig.*, 784 F. Supp. 1471, 1481 (N.D. Cal. 1992). And *see generally* Joseph Nocera, *Wall Street on the Run*, FORTUNE (June 14, 2004), at 106 (discussing why traditional business model for research departments now must drastically change).



injury.”<sup>23</sup> Some have opined that analyst bias cases fit this mold well.<sup>24</sup> Others are not so sure.<sup>25</sup>

This Article uses these quite familiar elements of a securities fraud claim as its roadmap for consideration of the strengths and weaknesses of the analyst bias cases. As a preliminary matter, Section I addresses the “in connection with” requirement and the substantial procedural effect its application has had in this context. Section II then reviews the basic requirement of a false statement or omission and the effect of characterizing analyst bias as one or the other. Section III assesses the materiality of analysts’ ratings and recommendations, as well as their failure to disclose various conflicts of interest. Section IV takes a close look at the scienter requirement in this setting. Section V explores reliance, and presumptions thereof, in analyst bias cases. Section VI addresses loss causation, and Section VII damages. As a brief concluding matter, Section VIII surveys the relevant statute of limitations and the district court split on the issue.

These Sections generally consist of multiple parts. First is a discussion of the basic law of the subject element of the 10(b) securities fraud claim, with emphasis on Second Circuit and other relevant general precedent that will apply to the analyst bias

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<sup>23</sup> *Lawrence v. Cohn*, 325 F.3d 141, 147 (2d Cir. 2003) *quoting* *Ganino v. Citizens Util. Co.*, 228 F.3d 154, 161 (2d Cir. 2000); *and see* *Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529, 534 (2d Cir. 1999) (alterations in original), *quoting* *Time Warner*, 9 F.3d at 264.

<sup>24</sup> *See, e.g.*, Gross, *supra* note 18, at 661; Phillip Ballard Kennedy, Note, *Investment Banking Conflicts: Research Analysts and IPO Allocations*, N.C. BANKING INST. 199, 219-223 (April 2003); Zamansky, *supra* note 18. Mr. Zamansky is a noted member of the plaintiffs’ bar, representing allegedly defrauded investors in class action suits.

<sup>25</sup> *See, e.g.*, Rosen, *supra* note 18; John F. X. Peloso and Francis S. Chlapowski, *Loss Causation: Who Was Responsible for the Market Bubble?* N.Y.L.J. (August 21, 2003), at 3. Mr. Rosen as well as Messrs. Peloso and Chlapowski are defense attorneys. *See also* John C. Coffee, Jr., *supra* note 18 (rendering a more mixed opinion on viability of private suits alleging analyst bias under 10(b), but framing the question thus: “Should the courts extend the already considerable reach of Rule 10b-5 to encompass liability for patently silly investment advice, largely on the ground that analysts were compensated to promote deals?”, and therefore reflecting a defense-oriented bias in this particular context).

class action suits. As applicable, each Section then includes in-depth factual and legal analysis of any scant precedent that existed on the topic of analyst and broker liability for research reports prior to the current spate of litigation, as well as analogous case law involving others who gave biased investment advice, extracting those nuggets of helpful reasoning or precedent that might impact the pending cases. And, where possible, each Section analyzes the current state of the pending class action suits, looking at the salient legal and relevant procedural issues raised. Ultimately, in each Section the author seeks to identify the best arguments in support of and against analyst liability in the case of tainted research.

Finally, this Article reconciles the interim conclusions on each element and concludes, in Section IX, with a discussion of the largest issues to be determined in pending litigation and the general outlook for analysts and broker-dealers still facing years of front line litigation and appeals on this topic.

## **Section I - “In Connection With”**

The language of 10(b) requires that any fraud or deception prosecuted thereunder have been committed “in connection with the purchase or sale of a security.” This element has been interpreted uniformly to exclude as plaintiffs in 10(b) cases those who chose to hold their securities in response to defendants’ misrepresentation(s) or omission(s).

In *Blue Chip Stamps, et al. v. Manor Drug Stores*,<sup>26</sup> the U.S. Supreme Court upheld the rule in *Birnbaum v. Newport Steel, Inc.*,<sup>27</sup> interpreting the “in connection with” requirement to exclude three classes of putative 10(b) plaintiffs, holders

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<sup>26</sup> 421 U.S. 723 (1975).

<sup>27</sup> 193 F. 2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

constituting the second of these.<sup>28</sup> At its core, the Birnbaum rule prohibited claims by those classes of plaintiffs who did not actively participate in the market in response to a defendant's alleged fraud.<sup>29</sup> Non-purchasers or non-sellers would necessarily be bringing suit based largely on oral versions of events that would be difficult to prove or disprove,<sup>30</sup> and which would inevitably get to trial, thereby increasing the potential for strike suits and the discovery abuses and extortionate settlements with which they are associated.<sup>31</sup>

Since *Blue Chip*, the Second Circuit has made it clear that "the requirement of fraud in connection with the purchase or sale of a security is not satisfied by an allegation that plaintiffs were induced fraudulently *not* to sell their securities."<sup>32</sup>

Many allegedly damaged investors claim to have bought stocks based on tainted research. But others, who also claim to have been damaged by the same alleged market manipulation, did not buy or sell shares in response to the analysts' biased research reports and recommendations, but simply held their stocks in reliance on analysts' continued rosy valuations, target prices, and recommendations. This latter group, the so-

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<sup>28</sup> Speaking of the classes of plaintiffs barred by the *Birnbaum* rule, the Court said "[s]econd are actual shareholders in the issuer who allege that they decided not to sell their shares because of an unduly rosy representation or a failure to disclose unfavorable material." *Blue Chip*, 421 U.S. at 737-38.

<sup>29</sup> According to the Court, "In the absence of the *Birnbaum* doctrine, bystanders to the securities marketing process could await developments on the sidelines without risk, claiming that inaccuracies in disclosure caused nonselling in a falling market and that unduly pessimistic predictions by the issuer followed by a rising market caused them to allow retrospectively golden opportunities to pass." *Id.* at 747.

<sup>30</sup> The difficulty of proving what "one would have done" might involve some of the following conjecture or speculation: would plaintiff have actually sold the shares, how many shares would she have sold, when would she have sold them, and might she have used the proceeds of sale to purchase – in that market – something that turned out to be even more worthless? See *Blue Chip Stamps*, 421 U.S. 758 n.2 (Powell, J. concurring).

<sup>31</sup> *Id.* at 739-413. See also Boone & McGowan, *Standing to Sue under SEC Rule 10b-5*, 49 TEX. L. REV. 617, 648-649 (1971) (arguing against expansion of litigation under 10b by those not purchasers or sellers). Congress has expressed elimination of vexatious "blackmail" or "strike" suits to be a goal of its securities legislation. *Blue Chip*, 421 U.S. at 740-41; see also Securities Litigation, 1994: Hearings on H.R. 417 Before the Subcomm. on Telecomm. and Fin. of the House Comm. on Energy and Commerce, 103d Cong. 118 (1994) (testimony of Donald C. Langevoort, Lee S. and Charles A. Speir Professor of Law, Vanderbilt Univ. School of Law) (arguing that procedural amendments contained in the Private Securities Litigation Reform Act of 1995 would help eliminate strike suits).

<sup>32</sup> *Abrahamson v. Fleschner*, 568 F.2d 862, 868 (2d Cir. 1977) (emphasis in original), citing *Blue Chip Stamps*, 421 U.S. at 737-38.

called “holders,” cannot allege that any fraud committed against them was “in connection with a purchase or sale of securities” as required by 10b.<sup>33</sup> Their cases, thus, have been remanded to state court. The Second and Ninth Circuits have ruled that such district court rulings are not appealable.<sup>34</sup>

The “holder” class action claimants in analyst bias cases are not left without a remedy, however. Given that their suits cannot be brought under the federal statutory securities fraud scheme, they may proceed in state court<sup>35</sup> even though ordinarily they would be barred from doing so by the Securities Litigation Uniform Standards Act.<sup>36</sup> State causes of action, assuming they are not time barred, might include such things as breach of contract,<sup>37</sup> breach of fiduciary duty,<sup>38</sup> breach of state unfair business practices<sup>39</sup>

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<sup>33</sup> See, e.g., *Lowe v. Salomon Smith Barney, Inc.*, 206 F.Supp.2d 442 (W.D.N.Y. 2002); *Korsinsky v. Salomon Smith Barney Inc.*, No. 01 Civ. 6085 (SWK), 2002 U.S. Dist. LEXIS 259 (S.D.N.Y. January 9, 2002); *McCullagh v. Merrill Lynch & Co.*, No. 01 Civ. 7322 (DAB) 2002 U.S. Dist. LEXIS 3758 (S.D.N.Y. March 5, 2002).

<sup>34</sup> *Spielman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 332 F.3d 116 (2d Cir. 2003); *United Investors Life Insurance Co. v. Waddell & Reed, Inc.*, 360 F.3d 960 (9th Cir. 2004); *Abada v. Charles Schwab & Co.*, 300 F.3d 1112 (9th Cir. 2002). The Seventh Circuit Court of Appeals recently disagreed. *Kircher v. Putnam Funds Trust*, No. 04-1495, 2004 U.S. App. LEXIS 13345 (7<sup>th</sup> Cir. June 29, 2004).

<sup>35</sup> In denying relief to nonpurchasers of securities, the Supreme Court noted that the harsh result for those unable to prove purchaser/seller status, including holders, was mitigated “to the extent that remedies are available to nonpurchasers and nonsellers under state law.” 421 U.S. at 739 n.9. A number of federal cases have recognized this outcome. See, e.g., *Gutierrez v. Deloitte & Touche, L.L.P.*, 147 F. Supp. 2d 584 (W.D. Tex. 2001) (holding that covered class actions alleging misrepresentations in connection with mere “holding” of a covered security are not removable to federal court under SLUSA); *Gordon v. Buntrock*, No. 00 Civ. 303, 2000 U.S. Dist. LEXIS 5977 at \*9-10 (N.D. Ill. April 28, 2000) (remanding a state law claim despite SLUSA because the complaint explicitly limited the class to all persons holding shares before any of the alleged misrepresentations took place).

<sup>36</sup> Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended at 15 U.S.C. §§ 77p and 78bb(f)). SLUSA provides that “no covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging ... an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security ....” 15 U.S.C. §§ 77p(b), 78bb(f). This law was enacted in 1998 to close a loophole in the PSLRA whereby “many class action plaintiffs avoided the stringent procedural hurdles erected by PSLRA by bringing suit in state rather than federal court.” *Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 107-108 (2d Cir. 2001).

<sup>37</sup> See, e.g., *Dacey v. Morgan Stanley Dean Witter*, 263 F. Supp. 2d 706 (S.D.N.Y. 2003)(alleging breach of contract based on violation of various professional standards).

<sup>38</sup> See, e.g., *Korsinsky v. Salomon Smith Barney, Inc.*, No. 01 Civ. 6085 (SWK), 2002 U.S. Dist. LEXIS 259 (S.D.N.Y. January 9, 2002)(alleging breach of fiduciary duty under New York common law).

<sup>39</sup> See, e.g., *Feitelberg v. Merrill Lynch & Co., Inc.*, 234 F. Supp. 2d 1043 (N.D. Cal.) aff’d 353 F.3d 765 (9<sup>th</sup> Cir. 2003) (alleging that defendants engaged in unfair business practices in violation of California

or consumer fraud statutes,<sup>40</sup> or even more general tort claims.<sup>41</sup> The merits of any such claims are beyond the scope of this Article.

Another question raised by the “in connection with” requirement is whether more tangential cases against analysts qualify.<sup>42</sup> A case in point is the WorldCom-related suit *In re TARGETS Sec. Litig.*<sup>43</sup> The plaintiffs in that case purchased so-called “Targeted Growth Enhanced Terms Securities With Respect to the Common Stock of MCI WorldCom, Inc., (‘TARGETS’)” derivative securities whose price was linked to WorldCom’s. They alleged claims under 10(b), inter alia, against Salomon Smith Barney and its star telecommunications analyst, Jack Grubman, based on allegedly tainted research and recommendations regarding WorldCom.<sup>44</sup> Construing 10(b) “broadly and flexibly,”<sup>45</sup> District Judge Denise Cote of the Southern District of New York found the plaintiffs’ claims to satisfy the requirement:

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Business and Professions Code § 17200); *Feitelberg v. Credit Suisse FirstBoston LLC*, No. C-03-3451 SC, 2003 U.S. Dist. LEXIS 19116 (N.D. Cal. October 21, 2003) (same).

<sup>40</sup> See, e.g., *Rowinski v. Salomon Smith Barney, Inc.*, No. 3:02cv2014, 2003 U.S. Dist. LEXIS 20918 (M.D. Pa. November 20, 2003) (alleging, inter alia, unjust enrichment and violation of Pennsylvania Deceptive Practices Act). The court in *Rowinski* dismissed plaintiffs’ state law-based claims without prejudice. *Id.* at \*13 n. 6 (noting that plaintiffs “may be able to assert claims under federal securities laws”).

<sup>41</sup> See, e.g., *Susan Salisbury, Delray Retiree Sues Over \$2 Million in Stock Losses*, PALM BEACH (FLA.) POST (August 15, 2003), at 1D (reporting on suit based on Florida tort of “outrage” brought against Salomon Smith Barney for allegedly repeatedly recommending plaintiff hold bad stocks, seeking only damages for mental pain and suffering caused by plaintiff’s losses on Worldcom stock).

<sup>42</sup> Other equally “tangential” cases are outside the scope of this Article, including those federal class actions that purport to state claims under other than 10(b), but also arising out of tainted research allegations. See, e.g., *Norman v. Salomon Smith Barney*, 03 Civ. 4391 (GEL), 2004 U.S. Dist. LEXIS 10619 (S.D.N.Y., June 8, 2004) (setting forth claims under Investment Advisors Act).

<sup>43</sup> Nos. 02 Civ. 3288 and 03 Civ. 9490 (DLC), 2004 U.S. Dist. LEXIS 11696 (S.D.N.Y. June 28, 2004).

<sup>44</sup> Cf. *In re WorldCom, Inc. Sec. Litig.*, 294 F. Supp. 2d 392 (S.D.N.Y. 2003) (describing allegations against WorldCom, its officers, directors, outside auditors and underwriters, as well as against Salomon Smith Barney and Grubman based on their tainted research reports, which failed to disclose an illegal “quid pro quo” relationship between SSB and Grubman on the one hand and WorldCom and its some of its officers on the other. *Id.* at 404-406).

<sup>45</sup> *In re Ames Dep’t Stores Inc. Stock Litig.*, 991 F.2d 953, 964-65 (2d Cir. 1993) (holding that the “in connection with” requirement should be construed broadly and flexibly to allow the securities fraud statute to capture novel frauds as well as more commonplace ones.)

The Complaint alleges a direct link between the value of the TARGETS securities and the alleged misrepresentations and omissions regarding WorldCom, and alleges that the plaintiffs bought TARGETS in reliance on the misrepresentations and omissions about WorldCom. There could be no serious argument that statements which are admittedly “in connection with” the purchase and sale of WorldCom stock were not also statements “in connection with” the trading in WorldCom options. Given the linkage between the value at redemption of TARGETS and the WorldCom stock price, it requires a very small extension of this principle to find that the plaintiffs have alleged a fraud in connection with the purchase and sale of TARGETS.<sup>46</sup>

Thus the “in connection with” element has proven to be a stumbling block really only for would be plaintiffs who were holders. For those suits that do surmount the “in connection with” hurdle, the first order of business is to allege and prove a misrepresentation or omission of fact. This basic element of a securities fraud case is discussed in the following section.

## **Section II – False Statements and Omissions**

### **(a) Misrepresentations and Omissions Generally**

In the right circumstances, either a misrepresentation and/or an omission can create 10(b) liability. As is true in any run of the mill fraud case, a misrepresentation is an assertion that is not in accord with the truth.<sup>47</sup> Unlike many investor class actions, the

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<sup>46</sup> In re TARGETS Sec. Litig., 2004 U.S. Dist. LEXIS 11696, at \*\*28-29.

<sup>47</sup> See, e.g., SEC v. Texas Gulf Sulphur, Co., 401 F.2d 833, 862-863 (2d Cir. 1968) (noting that the false or misleading nature of a statement must be considered “in light of the facts existing at the time” of the statement, in search of the statement’s “relationship to the truth”); RESTATEMENT (SECOND) OF CONTRACTS § 159. Outside the analyst liability context, though seemingly equally applicable to the analyst bias setting, the Second Circuit has stated that the misstatement violating 10(b) must relate to facts that “affect the probable future of the company and [that] may affect the desire of investors to buy, sell or hold

analyst bias cases tend not to involve allegations of misrepresented facts about the issuing companies, these types of claims usually being alleged against issuers themselves. Instead, the analyst bias cases typically allege that by issuing overly optimistic research reports and recommendations, analysts were publishing disingenuous opinions – the functional equivalent of falsehoods.

Alternatively, or in tandem, the suits tend to allege that the ratings and recommendations issued by analysts were misleading by omission. Omissions are actionable where defendants “omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.”<sup>48</sup> In the analyst bias cases, analysts’ research reports and other recommendations may have omitted the fact of their ownership interests in stocks researched, or they may have failed to disclose their firm’s investment banking relationship or desired relationship with the subject issuer, or the fact that an analyst’s compensation may have been tied to attraction or retention of that investment banking business from issuers the analyst covered.

Whether liability attaches to analysts’ subjective, predictive-type statements and whether omissions of the sort identified rendered the statements analysts did make misleading ones is an interesting question. What follows is a more specific discussion of the law of misrepresentations and omissions as it relates to analyst bias cases.

### **(b) Disingenuous Opinions as Misrepresentations**

From an objective standpoint, analysts’ ratings and recommendations are perhaps more like opinions and/or predictions rather than hard facts upon which investors are

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the company’s securities.” *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 179 (2d Cir. 2001) *quoting* *Texas Gulf Sulphur Co.*, 401 F.2d at 849.

<sup>48</sup> 17 C.F.R. 240.10b-5(b).

entitled to rely. Facts can generally be proven to be either true or false as of the time of their making.<sup>49</sup> Predictions cannot, but this does not mean they are inoculated from liability. It has long been held that predictions and forward-looking statements can be considered “facts” in the context of 10(b)’s fraud proscription.<sup>50</sup> If a prediction has no basis, or the maker of the prediction doubts its validity given other facts in his or her possession, liability will attach.<sup>51</sup> Similarly, even assuming optimistic research reports and attendant recommendations are viewed as opinions, the U.S. Supreme Court has held that there can be 10(b) liability for issuers’ statements of opinion when it can be shown either that the speaker intentionally misrepresented his actual opinion or that the opinion lacked any underlying justification.<sup>52</sup>

This rationale explains, in part, the basis for several pre-bubble suits against analysts and broker-dealers based on their public stock recommendations. For example, the Southern District of New York refused to dismiss a 10(b) class action captioned *In re Credit Suisse First Boston Corp. Sec. Litig.*<sup>53</sup> The suit was based on so-called “Trading Notes” CSFB had disseminated to investors in the form of a purported analyst’s research report containing a “sell” recommendation. In reality, the Trading Notes had been

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<sup>49</sup> Cf. *Harris v. Ivax Corp.*, 182 F.3d 799, 805 (11th Cir. 1999) (defining forward-looking statements for purposes of the PSLRA’s safe harbor provisions as those that are not presently verifiable).

<sup>50</sup> See, e.g., *Rubinstein v. Collins*, 20 F.3d 160, 166 (5th Cir. 1994) (stating that “it is . . . well-settled that Rule 10b-5 applies to predictive statements” and that “when necessary, courts have readily conceded that predictions may be regarded as ‘facts’ within the meaning of the antifraud provisions of the securities laws”); *Kowal v. MCI Communications Corp.*, 16 F.3d 1271, 1277 (D.C. Cir. 1994) (finding that if a company chooses to make predictions, “its disclosure must be full and fair” and stating that projections “are considered ‘statements of fact’ for purposes of the securities laws”).

<sup>51</sup> See, e.g., *Rubinstein*, 20 F.3d at 166 (finding that a predictive statement incorporates factual assertions, *inter alia*, that the statement has a reasonable basis and that the maker is unaware of any undisclosed facts that seriously undermine its validity); *Goldman v. Belden*, 754 F.2d 1059, 1068-69 (2d Cir. 1985) (predictions can be actionable where defendants have knowledge of facts that must have caused them to question their predictions).

<sup>52</sup> *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1093, 1095-96 (1991); *San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos.*, 75 F.3d 801, 812-13 & n.13 (2d Cir. 1996); *In re Apple Computer Secs. Litig.*, 886 F.2d 1109, 1113, 1116 (9th Cir. 1989).

<sup>53</sup> No. 97 CV 4760 (JGK), 1998 U.S. Dist. LEXIS 16560 (October 19, 1998 SDNY 1998)



prepared by the firm's proprietary trading group and an analyst's name affixed thereto without disclosure therein that CSFB held short positions in the two stocks that were portrayed negatively in the Notes. When it became public that the firm had profited from its short positions in the two issuers for which the negative ratings were published, the firm issued revised Notes and ultimately admitted that the Notes had been prepared outside its standard operating procedure and should not have been disseminated as they were.<sup>54</sup>

CSFB raised as a defense that the stock recommendations contained in the Trading Notes were merely non-actionable opinions.<sup>55</sup> In that regard, the court ruled that "statements of opinion are actionable under § 10(b) and Rule 10b-5 if they are made in bad faith or are not reasonably supported by evidence available to the person or entity that issues the statements."<sup>56</sup>

The Ninth Circuit had previously reached the same conclusion in another case involving analysts' stock recommendations. In *Cooper v. Pickett*,<sup>57</sup> a more dated suit, Lehman Brothers and Robinson-Humphrey were sued by investors for optimistic statements made by their analysts. In the context of reversing dismissal of the suit at the pleading stage, the Ninth Circuit made it clear that analyst's reports containing opinions can be actionable where they are "not genuinely and reasonably believed, or if the

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<sup>54</sup> *Id.* at \*\*3-7.

<sup>55</sup> Perhaps a more compelling argument was made that the opinions were immaterial. See notes \*-\* *infra*. [discussion of CSFB in materiality section]

<sup>56</sup> *Id.* at \*14, quoting *Kurzweil v. Philip Morris Cos., Inc.*, Nos. 94 Civ. 2373, 94 Civ. 2456, 1997 U.S. Dist. LEXIS 4451, \*26 (S.D.N.Y. Apr. 9, 1997), and further referring the reader to *Goldman v. Belden*, 754 F.2d 1059, 1068-69 (2d Cir. 1985), for the proposition that "predictions can be actionable where the defendants' knowledge of various facts must have caused them to have reservations about the predictions." *Id.*

<sup>57</sup> 137 F.3d 616 (9<sup>th</sup> Cir. 1996).

speaker is aware of undisclosed facts that tend seriously to undermine the statement's accuracy."<sup>58</sup>

Though scant, this precedent is directly on point, squarely answering in the negative the question whether analysts are protected merely by virtue of the fact their statements are mere "targets" (predictions) or "our judgment as of this date" (opinions). Given the variety of fact patterns involved in the cases that have been considered so far, though, their results have been less than uniform.

Proving an opinion to be disingenuous is not easy, as rarely is there direct evidence of the defendant's true thoughts. Therefore in analyst bias cases, plaintiffs seeking to base their 10(b) claims on false opinions are typically relying on circumstantial facts and allegations purporting to show inconsistency between what the analyst said and what he or she did.

For example in *DeMarco v. Robertson Stephens, Inc.*,<sup>59</sup> plaintiffs alleged that the analyst privately recommended his firm sell its shares just a week after his report's Buy recommendation and three days before he issued another rosy report with a Buy recommendation. The analyst and his employer-broker sold the bulk of their shares immediately after the analyst's secret "sell" recommendation was made internally.<sup>60</sup> These specific factual allegations, according to the court, were enough to permit a reasonable factfinder to infer that the "buy" recommendation contained in the defendants'

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<sup>58</sup> *Id.* at 629, *citing* *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1113 (9th Cir. 1989).

<sup>59</sup> No. 03 Civ. 590 (GEL), 2004 U.S. Dist LEXIS 265 (S.D.N.Y. January 8, 2004).

<sup>60</sup> *Id.* at \*\*13-14.

publicly available reports was not just bad advice but was a false statement of opinion, in that the defendant's real opinion was that (preferred) investors should sell.<sup>61</sup>

Not all plaintiffs have access to such persuasive inside information in making their cases. In a related suit involving the same defendants and district court judge, plaintiffs in *Podany v. Robertson Stephens, Inc.*,<sup>62</sup> were unable to overcome the falsity hurdle.<sup>63</sup> There, the defendant analyst was alleged to have issued false opinions regarding a proposed merger so as to “pump” the price of a stock he owned and on which he would stand to gain dearly if the merger upon which he reported and opined was consummated. However, there was no evidence and therefore no allegation that he “dumped” his stock inconsistently with his opinions.<sup>64</sup> In support of their false opinion argument, Plaintiffs maintained that the analyst had no reasonable basis for his opinion, that his ownership interest in the subject company was not disclosed, and that he had engaged in other similar frauds with other stocks.<sup>65</sup> The court found none of these claimed facts independently or in the aggregate was sufficient to adequately allege the necessary false or misleading statement in support of a 10(b) claim.<sup>66</sup> This ruling seems to have melded the misrepresentation element with the scienter element. If the analyst's opinion lacked a reasonable basis, he had failed to disclose a material conflict of interest, and he had acted in a similarly fraudulent way with other stocks, it appears that his

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<sup>61</sup> *Id.* at \*\*14-15. See also Judge Lynch's description of his ruling and rationale in the DeMarco case, in *Podany v. Robertson Stephens, Inc.*, 2004 U.S. Dist. LEXIS 2290 \*\*20-21 (S.D.N.Y. February 10, 2004).

<sup>62</sup> 2004 U.S. Dist. LEXIS 2290, (S.D.N.Y. February 10, 2004).

<sup>63</sup> See also *Ward v. UBS PaineWebber, Inc.*, No. Civ. No. 02-3878 (JAP), 2003 U.S. Dist. LEXIS 24056 (D.N.J. September 10, 2003). Ward filed a class action suit under 10(b) based on analyst Walter Piecyk, Jr.'s notorious \$1000 target price for Qualcomm stock. However, the court found that the complaint contained no allegations supportive of the notion that Piecyk's forward-looking statement was “not ‘genuinely and reasonably believed’ when made” citing *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 368 (3d Cir. 1993).

<sup>64</sup> *Id.* at \*\*5-13, \*21 n.3

<sup>65</sup> *Id.* at \*22.

<sup>66</sup> *Id.* at \*\*32-34.

statement was at least misleading. Whether he had intent to defraud (as evidenced perhaps by motive and opportunity, such as profiting from his conduct in falsely inflating a stock's price) is more a question of scienter.<sup>67</sup>

Unlike the circumstantial cases, some of the analyst bias complaints have been boosted by the publication of results of various administrative and governmental investigations into the analyst bias scandal. Several state attorneys general and the Securities Exchange Commission have released evidence in the form of email messages to and from analysts, many of which revealed that analysts did not believe in the very stocks they were touting, or that they gave higher ratings than they otherwise would have due to the pressures created by the investment banking conflict of interest.<sup>68</sup> In these cases, plaintiffs can fairly easily allege a prima facie case regarding the falsity of the analysts' opinions, assuming the contrary opinions or conflicts of interest discussed in the emails relate to the stock of which plaintiffs complain.

A case in point is *DeMarco v. Lehman Brothers Inc.*,<sup>69</sup> in which the plaintiff was able to take advantage of emails published by the SEC revealing in the analyst's own words that he did not legitimately hold the opinions he was pushing publicly.<sup>70</sup> The emails in the *Lehman* case took the form of a sell recommendation communicated privately to a preferred customer, an institutional investor, when in fact the analyst's

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<sup>67</sup> See *infra* Section \*.

<sup>68</sup> See, e.g., Susanne Craig, *Wall Street Stock Research at a Crossroads --- Betting on Overhaul, One Analyst Weighs Getting Back in Game*, WALL ST. J. (November 8, 2002) Section C, page 1 (describing CSFB e-mails discovered by Massachusetts Attorney General's investigation); Gretchen Morgenson, *Regulators Find More Red Flags in Another Analyst's Optimism*, N. Y. TIMES (September 12, 2002), Section C, page 1 (describing Donaldson, Lufkin & Jenrette e-mail messages uncovered in SEC's investigation into stock analysts' conflict of interest); Patrick McGeehan, *Merrill Lynch Under Attack as Giving Out Tainted Advice*, N. Y. TIMES (April 9, 2002), Section C, page 1 (describing e-mails revealed by New York Attorney General's investigation into Merrill Lynch).

<sup>69</sup> No. 03 Civ. 3470 (JSR), 2004 U.S. Dist. LEXIS 5026 (S.D.N.Y. 2004).

<sup>70</sup> *Id.* at \*3.

reports recommended “buy” to all other readers.<sup>71</sup> Similar so-called bad email cases include those in which the analysts’ internal email discussions with co-workers revealed their truly held opinions were contrary to those set out in their publicly disseminated reports.<sup>72</sup> The misrepresentation element is easily met in these cases, given the proof of false opinions.

But bad email allegations alone may not be enough where there is no direct connection between the stock plaintiffs bought and the specifics of the available email evidence. In *Pfeiffer v. Goldman, Sachs & Co.*,<sup>73</sup> plaintiffs’ amended complaint referred to analysts’ e-mail messages that had been discovered during an investigation by the Massachusetts Securities Division.<sup>74</sup> However, the emails to which plaintiffs referred did not discuss the stock that allegedly resulted in damage to plaintiffs.<sup>75</sup> Instead, plaintiffs used the emails as part of an effort to show that the defendants’ investment banking divisions had unreasonable influence over their analysts, thereby presumably tainting all of their research and recommendations.<sup>76</sup> This, the court did not condone, ruling that where there were no allegations tending to prove that defendants did not actually hold their stated opinions or that their investment banking divisions improperly influenced the reports targeted by plaintiffs, the complaint lacked any specific allegations that the ratings were “false,” failing the particularity requirement of the PSLRA.<sup>77</sup> The suit was

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<sup>71</sup> *Id.* at \*3, \*\*6-7. A brief email exchange between the analyst and the customer discussing the worthlessness of the stock concluded with the analyst stating, “we bank these guys so I always have to cut the benefit of the doubt.” *Id.*

<sup>72</sup> #Blodget-M/L cases? Others?

<sup>73</sup> No. 02Civ. 2912 (HB), 2003 U.S. Dist. LEXIS 11120 (June 30, 2003)

<sup>74</sup> *Id.* at \*7-8.

<sup>75</sup> *Id.* at \*8.

<sup>76</sup> *Id.* at \*16-17.

<sup>77</sup> *Id.* at \*17. In so ruling, the court referred to the “inherent subjectivity” of stock recommendations, and the “market’s seemingly boundless infatuation with internet technology stocks at that time” as

dismissed with prejudice,<sup>78</sup> and that result affirmed without comment by the Second Circuit in an unpublished opinion.<sup>79</sup>

On the other hand, Judge Shira Scheindlin of the Southern District has opined in a case with no email evidence that basic allegations of bias can suffice to support a finding that the analysts' opinions were misleading, because to hold otherwise would confound the elements of misrepresentation and scienter.<sup>80</sup> According to Judge Scheindlin, to satisfy 10(b), a statement must be objectively false (misrepresentation element), and also subjectively false, from both the defendant's perspective (the scienter element) and the plaintiff's perspective (the reliance element).<sup>81</sup> Judge Scheindlin, thus correctly reads Second Circuit precedent<sup>82</sup> and the Supreme Court's *Virginia Bankshares Inc. v. Sandberg*<sup>83</sup> as making an opinion actionable only where (1) it is not believed by the speaker (subjectively false) and it is (2) objectively false.<sup>84</sup> In her view, the former is the scienter inquiry and the latter's proper focus is whether the plaintiff has pleaded the

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preventing the court from buying the plaintiffs' conclusory allegations about falsity of the analysts' opinions. *Id.*

<sup>78</sup> *Id.* at \*20. Senior District Judge Pollack's dismissal of several of the Merrill Lynch cases is based, in part, on very similar grounds. In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig., (re 24/7 Real Media and Interliant), 273 F. Supp.2d 351, 370-371, 374-375 (S.D.N.Y. 2003) (no email evidence implicates stocks at issue in that case); In re Merrill Lynch Tyco Research Sec. Litig., No. 03 CV 4080 (MP), 2004 U.S. Dist. LEXIS 2247, \*12-14 (S.D.N.Y., February 18, 2004) (holding that plaintiffs failed to plead with sufficient particularity their allegation that the analysts recommendations "lacked any reasonable basis"). The former of these is discussed at more length in Section VI, *infra*, regarding loss causation.

<sup>79</sup> Weinstein v. Goldman, Sachs & Co., 93 Fed. Appx. 326 (2d Cir. 2004).

<sup>80</sup> Fogarazzo v. Lehman Bros., 03 Civ. 5194 (SAS), 2004 U.S. Dist. LEXIS 9193, \*53-55 (S.D.N.Y. May 21, 2004).

<sup>81</sup> *Id.* at \*51.

<sup>82</sup> See, e.g., In re Time Warner Sec. Litig., 9 F.3d 259, 265 (2d Cir. 1993); Goldman v. Belden, 1068-1069 (2d Cir. 1985); In re AOLTime Warner Sec. and "ERISA" Litig., No. 02 Civ. 5575 (SWK), 2004 U.S. Dist LEXIS 7917 (SDNY, May 5, 2004).

<sup>83</sup> 501 U.S. 1083 (1991) (holding that knowingly false statements of reasons, opinions, or beliefs contained in proxy solicitation are not per se inactionable under 14(a) of the 1934 Act).

<sup>84</sup> *Id.* at 1092-1096.

subject statements' "misleading" nature with particularity, as required by the Private Securities Litigation Reform Act.<sup>85</sup>

In any private action ... in which the plaintiff alleges that the defendant (A) made an untrue statement of a material fact, or (B) omitted to state a material fact ..., the complaint shall specify each statement alleged to have been misleading, [and] the reason or reasons why the statement is misleading.<sup>86</sup>

This requirement goes above and beyond the general mandate of Rule 9(b) of the Federal Rules of Civil Procedure requiring that alleged fraud be pled "with particularity,"<sup>87</sup> and it has been read to mean that the plaintiffs must allege the "who, what, how, when, where" of the fraud, especially why purportedly fraudulent statements are false or misleading and/or how it is alleged that any misstatements or omissions constitute fraud.<sup>88</sup>

From Judge Scheindlin's perspective, the following four allegations of bias identified in the plaintiffs' complaint adequately apprise defendants as to why their buy recommendations and price targets were "objectively" misleading:<sup>89</sup> (1) investment banking divisions improperly influenced research in an effort to gain lucrative investment banking business, (2) analysts had financial conflicts of interest regarding stocks they covered, (3) issuers were permitted to review analysts reports before they were issued, and (4) there was an unwritten rule discouraging downgrading stocks or assigning

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<sup>85</sup> *Id.* at \*54 n.123 (maintaining that the misleading nature of a falsehood and its deliberateness are different questions).

<sup>86</sup> 15 U.S.C. § 78u-4(b)(1).

<sup>87</sup> *See* F. R. CIV. PRO. 9(b) ("the circumstances constituting fraud or mistake shall be stated with particularity."). *See generally* Note, Pleading Securities Fraud Claims with Particularity Under Rule 9(b), 97 HARV. L. REV. 1432 (1984).

<sup>88</sup> *See, e.g.,* *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 980 (9<sup>th</sup> Cir. 1999); *Novak v. Kasaks*, 216 F.3d 300, 312 (2d Cir. 2000).

<sup>89</sup> *Id.* at \*57.

negative ratings to investment banking clients' stocks, all of which were alleged to have caused artificial price inflation.<sup>90</sup> Judge Scheindlin's ruling, thus, is the opposite of Judge Baer's in *Pfeiffer* and avoids the conflation of misrepresentation and scienter from which Judge Lynchs' ruling in *Podany* suffered.

Judge Scheindlin's reading of *Virginia Bankshares* is more consistent with that case's tenor and with its 10(b) progeny in the Circuit Courts.<sup>91</sup> The falseness of a prediction, or the misleading nature of a statement or omission satisfies the required *objective* falsity, while *subjective* falsity of the same statement or omission is a distinct inquiry: scienter. Confusion does arise with regard to the narrow category of misrepresentations consisting of opinions, as opposed to exaggerated or false facts, baseless predictions, or even straight forward omissions to state facts bearing materially on the speakers' statements. In a case where an opinion is not genuinely held, its falsity implies both misrepresentation (falsity) and intentional deception (scienter). But not all of the statements and omissions made by analysts were strictly opinions. Some were more in the nature of predictive statements (target prices, for example), and outright omissions. In these cases, falsity and scienter must be viewed separately.

While there is merit to Judge Scheindlin's more narrow approach to the objective falsity of analysts' statements perhaps a simpler means to achieve the same end would simply have been to classify the case (and she may have implicitly done so) as one

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<sup>90</sup> *Id.* at \*55-57. In several cases before Senior Judge Pollack, the court dismissed plaintiffs claims based in large part on the fact they had failed to succinctly identify the statements they claimed were misleading, had failed to specify the reasons the reports were misleading, and otherwise failed to plead the alleged misrepresentations or omissions with sufficient particularity. *See, e.g.*, In re Merrill Lynch Research Reports Sec. Litig. (Tyco), No. 03 CV 4080 (MP), 2004 U.S. Dist. LEXIS 2247 \*13-\*14 (S.D.N.Y., February 18, 2004); In re Merrill Lynch Research Reports Sec. Litig. (24/7 Real Media and Interliant), 273 F. Supp. 2d. 251, 271 (S.D.N.Y. 2003).

<sup>91</sup> *See, e.g.*, Miller v. Asensio & Co., Inc., 364 F.3d 223, 228 n.3 (4<sup>th</sup> Cir. 2004); Grossman v. Novell, 120 F. 3d 111, 1120 n. 6 (10<sup>th</sup> Cir. 1997); Glassman v. Computervision Corp., 930 F.2d 617, 627 (1<sup>st</sup> Cir. 1996); In re Donald Trump Casino Sec. Litig., 7 F.3d 357, 372 (3d Cir. 1993).



involving omissions to state the four material facts set forth above, in which case the question of opinions may have been sidestepped altogether.

The classification of a given case as one involving misrepresentations or omissions has some of the same potential for confusion as does the confounding of falsity and scienter when opinions are at issue. Viewed one way, analysts' reports were either false opinions not genuinely held or they were misleading (and therefore misrepresentations under 10(b)) because they failed to disclose arguably material conflicts of interest. On the other hand, they could be seen as omissions to state material facts. The next subsection addresses the 10(b) law of omissions.

#### **(b) Omissions**

Given the nature of the "tainted" research fact patterns, and the essentially predictive or subjective quality of their statements, it can be difficult to label them as either strictly misrepresentations or omissions. But this classification as omission or misrepresentations is important for a number of reasons. First, as discussed further below, where omissions are involved, not only materiality, but a duty to speak must be proven. Second, and perhaps more importantly, a presumption of reliance is permitted where material omissions are involved, while the presumption of reliance for misrepresented information may have to be based on the fraud-on-the-market theory, which is in question in this context, as discussed more fully in Section VI below.

Overlapping with the cases complaining that defendant analysts rendered false opinions are those in which the allegations center on omitted facts: the investment banking-research conflict of interest, analysts' tied compensation schemes, and/or analyst or brokerage ownership position in covered stocks, or in at least one case, an alleged

“quid pro quo arrangement” between the analyst/broker-dealer on one hand and an issuer on the other hand, for positive ratings and recommendations and inside access to hot IPO stocks for the issuer’s executives in exchange for lucrative investment banking and other business.<sup>92</sup>

There is precedent, outside the realm of analyst bias as herein defined, for the proposition that failure to disclose important conflicts of interest can result in liability for those giving stock recommendations. Recently, allegations of an undisclosed conflict of interest were made in a 10(b) claim against an analyst in *Cybermedia Group Inc. v. Island Mortgage Network, Inc.*<sup>93</sup> Courtney Smith, a financial analyst, money manager, and entrepreneur, who regularly appears on financial news programs,<sup>94</sup> claimed in an appearance on CNN that stock in Apponline.com (“AOP”) was a “double your money” investment. Plaintiffs alleged that at the time of Smith’s recommendation of AOP, he was negotiating with venture capital company called Inculab to act as its CEO. As part of any proposed compensation package with Inculab, Smith stood to receive Inculab stock, which was directly tied to the value of AOP since Inculab had a significant investment in AOP.<sup>95</sup> Plaintiffs also alleged that Smith’s statement on CNN caused the price of AOP to “surge.”<sup>96</sup>

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<sup>92</sup> This latter is the thrust of the plaintiffs’ case against infamous telecom analyst Jack Grubman and his employer and broker-dealer Salomon Smith Barney (now a division of Citigroup known simply as Smith Barney), relating to putative artificial inflation of WorldCom stock price. *See, e.g.,* In re WorldCom Inc. Sec. Litig., 294 F. Supp. 2d 392 (S.D.N.Y. 2003) (referring to undisclosed relationship between analyst and broker dealer on one hand and issuer and its executives on the other as “illicit”).

<sup>93</sup> 183 F.Supp.2d 559 (E.D.N.Y. 2002).

<sup>94</sup> *See* <http://www.courtneysmithco.com>, last visited 06/03/04.

<sup>95</sup> 183 F. Supp. 2d at 567.

<sup>96</sup> *Id.*

The court denied Smith's motion to dismiss. He had argued his "double your money" statement not a misrepresentation but was immaterial puffery,<sup>97</sup> but the court ruled that no complaint should be dismissed unless the utterance was "so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question," and reasonable minds could differ here.<sup>98</sup> The court bolstered its ruling with two further comments lacking any accompanying analysis: "Furthermore, the Amended Complaint states that Smith knew that the statement was false at the time it was made and Smith's failure to disclose his impending conflict of interest could constitute a material omission."<sup>99</sup>

This latter comment exemplifies the linkage between omissions and their materiality. In fact, the discussion in most cases involving omissions revolves around materiality, which is discussed in more depth below.

### **Section III – Materiality**

As neither a misrepresentation nor an omission can form the basis for 10(b) liability unless it is material, it is common for the defense in 10(b) cases to argue immateriality. Generally the materiality inquiry will take one of several forms, typically dependent upon whether a misrepresentation or omission has been alleged.<sup>100</sup> If what has been alleged is a misrepresentation, it must be of a material fact. Alternatively, a plaintiff

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<sup>97</sup> The court seemed inclined to view the statement that way as well, remarking as follows:

... it seems that it would be unreasonable for an investor to base an investment decision on one analyst's assertion that a particular stock's value would double or that such an assertion could be more than mere puffery or optimism, reasonable minds may differ as to whether the particular statement is material.

*Id.* at 573.

<sup>98</sup> *Id.* at 573, *quoting* *Ganino v. Citizens Util. Co.*, 228 F.3d 154, 162 (2d Cir. 2000) (citing *Goldman v. Belden*, 754 F.2d 1059, 1067 (2d Cir. 1985)).

<sup>99</sup> 183 F. Supp. 2d at 573.

<sup>100</sup> It is not entirely clear that the analysis engaged in by the courts always depends on what has been pled. Instead, because of the interrelated and often overlapping nature of misrepresentations and omissions, the analysis may be driven by the court's own perspective on what has been alleged, or the court's reaction to defense framing of the arguments.

can allege that an omission rendered the affirmative statement(s) misleading in a material way. Finally, there is allegation that the defendant omitted to state a material fact. When the latter is alleged, plaintiff must also plead and prove a duty to disclose the omitted information, which at its core devolves into an inquiry into the omitted information's materiality.

**(a) The Materiality of Omitted Information Under 10(b)**

In the context of an issuer's failure to disclose merger negotiations, the U.S. Supreme Court in *Basic, Inc. v. Levinson*,<sup>101</sup> expressly adopted the *TSC Indus. Inc. v. Northway Inc.*<sup>102</sup> test for materiality of omitted information for use in 10(b) cases: "to fulfill the materiality requirement 'there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.'"<sup>103</sup> In *Basic*, the Court found that the existence of merger negotiations could in certain circumstances constitute material information, but it expressly declined to opine about the application of its materiality test to "other kinds of contingent or speculative information, such as earnings forecasts or projections."<sup>104</sup>

Even before *Basic*, however, the U.S. Supreme Court had had occasion to discuss materiality in the context of a 10(b) omission of facts in the case of *Affiliated Ute Citizens of Utah v. U.S.*<sup>105</sup> There, a bank was employed to act as a transfer agent for Indian owners of stock in an Indian asset management and protection company. Two employees

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<sup>101</sup> 485 U.S. 224 (1988).

<sup>102</sup> 426 U.S. 438 (1976).

<sup>103</sup> 485 U.S. at 231-232.

<sup>104</sup> *Id.* at 232 n.9, referring the reader generally to Bruce A. Hiler, *The SEC and the Courts' Approach to Disclosure of Earnings Projections, Asset Appraisals, and Other Soft Information: Old Problems, Changing Views*, 46 MD. L. REV. 1114 (1987).

<sup>105</sup> 406 U.S. 128 (1972).

of the bank engaged in a scheme to develop a non-Indian market for the stock, and they purchased such stock from Indians for themselves and other non-Indians at depressed prices without disclosing their market making activities.<sup>106</sup> The Court had no difficulty in finding that the omitted information was material, stating as a prelude to its now famous holding eliminating the need for individual reliance when an omitted statement is material: “The [Indian] sellers had the right to know that the defendants were in a position to gain financially from their sales ....”<sup>107</sup>

The Second Circuit has applied the *Basic* materiality test in a variety of different securities fraud settings.<sup>108</sup> A slightly different formulation has been applied in the Second Circuit as well: “To be material, the information need not be such that a reasonable investor would necessarily change his investment decision based on the information, as long as a reasonable investor would have viewed it as significantly altering the ‘total mix’ of information available.”<sup>109</sup>

It seems clear that under either version of the materiality test, and given the existing precedents, the analyst bias cases alleging omission of facts describing conflicts of interest such as the investment banking influence or analyst/brokerage ownership of covered stocks would be deemed material. Echoing the U.S. Supreme Court in *Affiliated Ute*, investors had a right to know of analysts’ potential motives in touting certain stocks.

#### **(b) Existing Precedent**

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<sup>106</sup> *Id.* at 150.

<sup>107</sup> *Id.* at 153. *See also* Chasins v. Smith Barney & Co., 438 F.2d 1167, 1172 (2d Cir. 1970) (finding broker’s nondisclosure of fact it was market-maker for recommended security to be material).

<sup>108</sup> *See, e.g., ###; Securities and Exchange Comm’n v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1467-68 (2d Cir. 1996)(finding material a broker’s failure to disclose its markups on stocks being sold, such that the price was not being set by the open market).

<sup>109</sup> *SEC v. Mayhew*, 121 F.3d 44, 52 (2d Cir. 1997), *citing* *TSC Indus. v. Northway*, 426 U.S. 438, 449, (1976).

In *CSFB Sec. Litig.*, another defense raised was that any omission in its Trading Notes was immaterial. The court held that the plaintiffs had adequately pled facts sufficient to resist a motion to dismiss, stating: "... a reasonable trier of fact could conclude that the failure to disclose CSFBC's short positions was a failure to disclose material facts necessary to make the projections not misleading."<sup>110</sup> Further in its defense, the firm argued that its failure to disclose its interest in the two stocks it recommended investors sell could not be actionable absent a duty to disclose, citing *Chiarella v. United States*.<sup>111</sup> The court made quick work of this argument, noting that while there may be instances in which one has no duty to speak, when one chooses to speak, one must make full and fair disclosure. For the court, this argument actually collapsed back into a question of materiality: "Moreover, the failure to disclose that market prices are being artificially depressed operates as a deceit on the marketplace and is an omission of a material fact."<sup>112</sup>

Relatively uncomplicated and succinct, the *CSFB* opinion stands for the simple proposition that a biased research analyst recommendation is misleading in a material way, whether it is classified specifically as a misrepresentation or an omission.

Bolstering this conclusion are a number of published opinions in cases that have been permitted to proceed against other persons recommending stocks as well as against investment advisors, or retail "stock brokers" – those with direct contact with the investors who purchase from broker dealers – based on allegations of false investment

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<sup>110</sup> *Id.* at \*15.

<sup>111</sup> 445 U.S. 222 (1980). It is noteworthy for purposes of this discussion that *Chiarella* was an insider trading case brought under SEC Rules 10b-5(a) and (c), prohibiting the use of "any device, scheme, or artifice to defraud" and "any act, practice, or course of business" that would operate as such, as opposed to 10b-5(b), which expressly proscribes untrue statements of material fact and/or omissions that render the facts asserted misleading. *Id.* at 225 n.5.

<sup>112</sup> *In re CSFB*, 1998 U.S. Dist. LEXIS 16560 at \*17.

advice or undisclosed conflicts of interest. Some of these cases involve the practice of an investment advisor trading on the effect of his recommendation, which is known as “scalping.”<sup>113</sup> Though not always precisely on point in part because they are typically brought under the Investment Advisors Act of 1940 (as opposed to 10(b)),<sup>114</sup> these cases can shed some light on various elements of a 10(b) claim. In many instances, the facts that have been alleged against non-analyst defendants parallel those being asserted today in the analyst bias cases. At a minimum they are quite analogous.

Like *CSFB*,<sup>115</sup> the non-analyst cases generally have found to be material the fact an investment advisor or other person giving investment advice has a stake in the security or its issuer, or that he otherwise stood to gain from the sale in an undisclosed manner. The governing principle in this area, emanating from the U. S. Supreme Court in a non-10(b) case, is that an investor has a right to know this type of information so as to fully consider the motivations of the one making the stock recommendation:

An adviser who, like respondents, secretly trades on the market effect of his own recommendation may be motivated -- consciously or unconsciously -- to recommend a given security not because of its potential for long-run price increase (which would profit the client), but because of its potential for short-run price increase in response to anticipated activity from the recommendation (which would profit the adviser). An investor seeking the advice of a registered investment adviser must, if the legislative purpose is to be served, be permitted to

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<sup>113</sup> See Gross, *supra* note \* at 637.

<sup>114</sup> Cf. *Zweig v. Hearst*, 594 F.2d 1261 (9<sup>th</sup> Cir. 1979), a case against journalist who recommended stocks in his column, and not arising from Investment Advisor’s Act, but instead under 10(b). *Id.* at 1267.

<sup>115</sup> See text accompanying notes \*.\*. The court in that case said “a reasonable investor would have discounted the projections in the report if the investor had been aware of CSFBC’s self-interest.” *Credit Suisse*, 1998 U.S. Dist. LEXIS 16560, at \*19-20.

evaluate such overlapping motivations, through appropriate disclosure, in deciding whether an adviser is serving “two masters” or only one, “especially . . . if one of the masters happens to be economic self-interest.”<sup>116</sup>

This is true even if the investor might not have changed his investment decision as a result.<sup>117</sup>

Several circuit court cases against non-analysts have borne this rationale out. For example, the Ninth Circuit Court of Appeals considered materiality of omitted information in the 10(b) context in *Zweig v. Hearst*.<sup>118</sup> The defendant in the case was a journalist who recommended stocks of small regional companies in his columns. What he did not tell readers, though, was that he typically purchased shares in the issuer before writing it up, such that he stood to gain if the column induced increased sales and pushed the price of these otherwise thinly traded stocks up.<sup>119</sup> Buying the plaintiffs’ argument that 10(b) required disclosure so that investors could for themselves analyze the columnist’s objectivity, the court found that the omitted information was material.<sup>120</sup> The court’s rationale was particularly compelling:

Had [defendant columnist’s] story objectively reported an undisputed fact or news event, such as the discovery of a valuable mineral deposit or the declaration of a dividend, his ownership of [the stock he touted] might not have been significant in reasonable investors' minds. But given the column's style and tone, with its

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<sup>116</sup> *Capital Gains*, 375 U.S. at 196 (note omitted). The finding of materiality of the omitted information was a predicate to the Court’s ruling in the case that such an omission operated as a “fraud or deceit” within the context of Section 206 of the Investment Advisors Act. 15 U.S.C. §80b-6(2).

<sup>117</sup> *SEC v. Mayhew*, (2d Cir) *citing* *TSC Indus. v. Northway*.

<sup>118</sup> 594 F.2d 1261 (9<sup>th</sup> Cir. 1979).

<sup>119</sup> *Id.* at 1264.

<sup>120</sup> *Id.* at 1266. In the court’s view, the journalist defendant’s activities were sufficiently similar to those of the bank employees’ in *Affiliated Ute* to impose upon him a duty to disclose this material information. *Id.* at 1268.



glowing praise of [the stock] and conclusion that the firm was a worthy investment despite its risks, the effect of [the journalist's] stock ownership on his objectivity would be important to his readers. We conclude, therefore, that the omitted facts alleged as violations were material.<sup>121</sup>

Likewise, the Sixth Circuit in *SEC v. Blavin*<sup>122</sup> held that an investment advisor's ownership of 25%, 10% and 10% respectively, of companies he recommended in a monthly newsletter was material as a matter of law, stating that "the effect of such large holdings on Blavin's objectivity in making investment recommendations would be particularly important to his clients."<sup>123</sup>

While not involving analysts per se, these cases involved defendants who provided much the same service and who may have had many of the same motivations as today's analyst bias defendants. As such, they serve as strong authority for the proposition that a failure to disclose financial motivations associated with stock recommendations is a material omission under 10(b).

### **(c) Duty to Disclose**

Related to the materiality of omissions is the question of the speaker's duty to disclose any omitted information. On that point, the Second Circuit has held that one who recommends stocks must disclose facts that might indicate an adverse interest or even just "overlapping" motivations for the recommendation. In *Chasins v. Smith Barney*,<sup>124</sup> the broker-dealer failed to disclose it was a market maker in the securities it recommended to the plaintiff. Even though proof at trial tended to indicate that the

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<sup>121</sup> *Id.* at 1266.

<sup>122</sup> 760 F.2d 706 (6th Cir. 1985)

<sup>123</sup> *Id.* at 711.

<sup>124</sup> 438 F.2d 1167 (2d Cir. 1967).

plaintiffs may have gotten better prices than they would otherwise have obtained in their over-the-counter stock purchases, the court found that the omitted information was material and therefore its disclosure required under 10(b). Using a rationale that appears to be equally forceful in the analyst bias cases, the *Chasins* court stated:

Here, Smith, Barney's strong recommendations of the three securities Chasins purchased could have been motivated by its own market position rather than the intrinsic desirability of the securities for Chasins. An investor who is at least informed of the possibility of such adverse interests, due to his broker's market making in the securities recommended, can question the reasons for the recommendations. The investor, such as Chasins, must be permitted to evaluate overlapping motivations through appropriate disclosures, especially where one motivation is economic self-interest.<sup>125</sup>

A number of other courts have followed *Chasins* in holding that an undisclosed financial interest is material and must be disclosed by one making stock recommendations.<sup>126</sup>

#### **(d) The Pending Analyst Bias Cases**

Specifically in the analyst bias cases, the materiality discussion tends to take two different forms. The first defense argument in this context is that any allegedly omitted

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<sup>125</sup> *Id.* at 1172.

<sup>126</sup> *See, e.g.,* Addeo v. Braver, 956 F. Supp. 443, 452 (S.D.N.Y. 1997) (rejecting argument that potential conflict of interest created by undisclosed commissions was immaterial, as a matter of law, even though the amount thereof was small); SEC v. Hasho, 784 F. Supp. 1059, 1109-1110 (S.D.N.Y. 1992) (finding that "failure to disclose such commissions deprives the customer of the knowledge that his registered representative might be recommending a security based upon the registered representative's own financial interest rather than the investment value of the recommended security."); Shivangi v. Dean Witter Reynolds, Inc., 107 F.R.D. 313, 318 (S.D. Miss. 1985) (holding that "the extra compensation received by [salespeople] in principal trades in which [broker dealer] makes a market, over and above the compensation normally received in agency trades, creates a potential conflict of interest which is a material fact which ought by law to be disclosed to investors"); Barthe v. Rizzo, 384 F. Supp. 1063, 1067 (S.D.N.Y. 1974) (holding, as regards materiality, that "[customer] was entitled to know that [salesperson] was in a position to gain financially" from the stock recommendation). *See also* Grandon v. Merrill Lynch & Co., 147 F.3d 183, 193 (2d Cir. 1998) (holding that broker dealer violates 10(b) by failing to disclose excessive markups in sales of municipal bonds).

information was immaterial and therefore need not have been disclosed. The second is the contention that the omitted information was adequately disclosed contemporaneously with the analysts' recommendations, or otherwise available to plaintiffs, or that sufficient cautionary language was provided in their reports so as to render the misstatements or omissions immaterial as a matter of law.

### **(1) Disclosure Not Required**

Perhaps given the amplitude of the authority for the proposition that the omitted conflicts of interest were material and therefore there was a duty to disclose them, defendants in the pending analyst bias case have not been particularly successful in arguing to the contrary.<sup>127</sup> Generic arguments to this effect have been met with a very stock judicial response,<sup>128</sup> or a finding that the disclosures defendants did make were not nearly specific enough.<sup>129</sup>

In an argument related to duty to disclose generally, the *Worldcom* defendants argued that they were in compliance with all relevant NASD and NYSE rules<sup>130</sup> by making the following disclosures or similar in their published research reports:<sup>131</sup>

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<sup>127</sup> The exception here is the Merrill Lynch Fund cases pending before Judge Pollack. These cases were asserted by mutual fund owners alleging some of the same factual predicates, but brought under Sections 11 and 12 of the 1933 Act. In that context, inter alia, Judge Pollack found there to be no duty to disclose the conflicts of interest alleged. *See, e.g.,* In re Merrill Lynch Research Reports Sec. Litig. (Internet Strategies Fund), 289 F. Supp. 2d 429, 434 (2003).

<sup>128</sup> *See infra* notes \* [apx 133-137] and accompanying text.

<sup>129</sup> *See also* In re Credit Suisse First Boston Corp. Sec. Litig., No. 97 Civ. 4760 (JGK), 1998 U.S. Dist. LEXIS 16560 at \*21-22 (S.D.N.Y. October 19, 1998) (holding that a party may not rely on a general disclaimer when he knows of specific adverse information that is not disclosed).

<sup>130</sup> Defendants cited to subsections (a) and (b) of Conduct Rule 2100(d)(2)(B)(i) of the 2000 NASD Manual (the NYSE's rules are parallel), which require research reports to disclose market making activities, the fact that the broker dealer may engage in sales with clients as a principal, and any potential ownership interest in the stock researched. A related argument was unsuccessfully made by defendants in *Newton v. Merrill Lynch, Pierce, Fenner & Smith*, 135 F.3d 266, 274 (3<sup>rd</sup> Cir. 1998) (en banc) (holding that employment of an industry standard practice could still be fraudulent behavior violative of 10(b), unanimously reversing district court's summary judgment in favor of defendants).

<sup>131</sup> 294 F.Supp. 2d 392, 430.

Within the past three years, Salomon Smith Barney, including its parent, subsidiaries and/or affiliates, has acted as manager or co-manager of a public offering of the securities of this company. . . .

Salomon Smith Barney, including its parent, subsidiaries and/or affiliates ("the Firm"), may from time to time perform investment banking or other services for, or solicit investment banking or other business from, any company mentioned in this report . . . . The Firm, or any individuals preparing this report, may at any time have a position in any securities or options of any of the issuers in this report. An employee of the Firm may be a director of a company mentioned in this report.<sup>132</sup>

The court made swift work of this argument, finding that these boilerplate disclosures were not enough to apprise the public of the specific conflicts of interest omitted by defendants.<sup>133</sup> Moreover, the court pointed to the more general NASD and NYSE rule requiring analysts and broker-dealers to deal fairly and in good faith and to avoid omitting any "material fact or qualification" which "in the light of the context of the material presented, would cause the communication to be misleading."<sup>134</sup> This folds any regulatory inquiry back into a 10(b) analysis, which is appropriate for the court and not preempted by SEC rules mandating certain disclosures.<sup>135</sup>

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<sup>132</sup> *Id.*

<sup>133</sup> *Id.* See also *La Grasta v. First Union National Bank*, 358 F.3d 840 (11<sup>th</sup> Cir. 2004). There the court ruled that such boilerplate did not put plaintiffs on notice for purposes of the statute of limitations, and intimating in *dicta* that instead, the cautionary language suggests that "that the report reflected [the analyst's] unbiased judgment of the value of the stock based on her research," perhaps in fact supporting an argument that the recommendations and ratings were misleading statements. *Id.* at 850-581

<sup>134</sup> Conduct Rule 2210(d)(1)(A), NASD Manual (2000). In fact, there were arguably a number of other professional standards and industry rules that prohibited this sort of conduct on the part of analysts and their employers. See *Olazábal and Robinson*, *supra* note \*.

<sup>135</sup> 294 F. Supp. 2d at 430-431, *citing* *Press v. Quick & Reilly, Inc.*, 218 F.3d 121, 131 (2d Cir. 2000).

The best the defense has mustered in the pending cases is argumentation based on the “bespeaks caution” doctrine, though generally unsuccessfully, discussed next.

## **(2) Immateriality Due to Accompanying Cautionary Language**

By definition, the misinformation alleged to have been provided by a defendant is simply part and parcel of a “total mix” of information that is available in the public domain. Where that total mix of information included the facts the defendants omitted, or it otherwise added the necessary grain of salt to the defendant’s misrepresentations, defendants argue, the price of the stock already reflected the truth, and therefore no harm was done.<sup>136</sup> Alternatively stated, and hearkening back to the pre-PSLRA “bespeaks caution” doctrine,<sup>137</sup> no statement is material if it is effectively counterbalanced by cautionary language that is of sufficient “intensity and credibility” to neutralize it.<sup>138</sup>

Since 1995, issuer defendants have also been able to take advantage of a codified version of the “bespeaks caution” doctrine. Under the PSLRA, a safe harbor is available for forward-looking statements made by issuers and underwriters, as long as these are accompanied by meaningful cautionary language.<sup>139</sup> Some have questioned the safe

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<sup>136</sup> This defense argument necessarily implicates not only the materiality element, but also the reliance and even loss causation elements. See *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1425 (3d Cir. 1997) (granting motion to dismiss because, as release of the information *did not affect the company’s stock price*, the information in question was not material).

<sup>137</sup> See, e.g., *Virginia Bankshares v. Sandberg*, 501 U.S. 1083, 1097 (1991) (“While a misleading statement will not always lose its deceptive edge simply by joinder with others that are true, the true statements may discredit the other one so obviously that the risk of real deception drops to nil.”); *Halperin v. eBanker USA.com, Inc.*, 295 F.3d 352 (2d Cir. 2002); *In re Donald Trump Casino Sec. Litig.*, 7 F.3d 357 (3d Cir. 1993). See generally Ann Morales Olazábal, *Safe Harbor for Forward Looking Statements Under the Private Securities Litigation Reform Act of 1995: What’s Safe and What’s Not?*, 105 DICK. L. REV. 1, 9-11 (Fall 2000); Jennifer O’Hare, *Good Faith and the Bespeaks Caution Doctrine: It’s Not Just Another State of Mind*, 58 U.PITT.L.REV. 619 (1997).

<sup>138</sup> *In re Apple Computer Sec. Litig.*, 886 F.2d. 1109, 1114-1115 (9<sup>th</sup> Cir. 1989) (court’s discussion of neutralizing information demonstrates the interrelation between materiality and reliance findings); .

<sup>139</sup> 15 U.S.C. § 78u-5 15 U.S.C. § 78u-5(a)(4).

harbor's availability to analysts' opinions.<sup>140</sup> Regardless of whether analysts' statements are covered by the safe harbor, its common law version – the “bespeaks caution” doctrine – remains.

Sometimes alternatively referred to as the “truth on the market” defense,<sup>141</sup> in the analyst bias cases this argument takes several different shapes. First is the position that other statements in the analyst's reports disclosed the high risk nature of the investment at issue, perhaps neutralizing the analyst's high opinion of the stock. Second is the contention that the reports themselves disclosed conflicts like ownership interests in the stock recommended or the goal of obtaining or retaining investment banking business from the issuer. Last is the possibility that there was enough popular press and other publicly available information to adequately apprise investors of the conflicts of interest inherent in analysts' recommendations.

A “bespeaks caution” argument was made and rejected in *DeMarco v. Lehman Brothers Inc.*,<sup>142</sup> in which the defense maintained that because the subject research

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<sup>140</sup> It is an open question whether reports issued after the quiet period by underwriters' analysts are covered by the safe harbor, given that such analysts are not acting on behalf of the issuer and are not themselves underwriters. See Richard A. Rosen, “*The Implications of The Private Securities Litigation Reform Act The Statutory Safe Harbor For Forward-Looking Statements After Two and a Half Years: Has it Changed the Law? Has it Achieved What Congress Intended?*,” 76 WASH. U. L. Q. 645, 648 (1998).

<sup>141</sup> This is a play on the name of the famous reliance presumption known as the “fraud on the market” doctrine. Like the “bespeaks caution” doctrine, some view the “truth on the market” defense as one relating to materiality, others see it as a matter of reliance. It has been adopted by the Second, Fourth, Fifth, Seventh, and Ninth Circuits. See *Ganino v. Citizens Util. Co.*, 228 F.3d 154, 167 (2d Cir.2000) (recognizing truth on the market can render a misrepresentation immaterial, and noting that because the defense is “intensely fact-specific [it] is rarely an appropriate basis for dismissing a section 10(b) complaint”); *Provenz v. Miller*, 102 F.3d 1478, 1492 (explaining that if the market has become aware of concealed information, the facts omitted by defendant would already be reflected in stock's price, and the market will not be misled); *Cooke v. Manufactured Homes, Inc.*, 998 F.2d 1256, 1262-63 (4th Cir. 1993) (affirming summary judgment where the market was fully aware of true information despite misrepresentation); *Associated Randall Bank v. Griffin, Kubik, Stephens, & Thompson, Inc.*, 3 F.3d 208, 213-14 (7th Cir. 1993) (noting that “truth-on-the-market” is a corollary to the “fraud-on-the-market” doctrine); *Fine v. Am. Solar King Corp.*, 919 F.2d 290, 299 (5th Cir. 1990) (stating that presumption of reliance may be rebutted by showing market was unaffected by misrepresentation); *In re Apple Sec. Litig.*, 886 F.2d at 1115 (recognizing possibility of rebutting presumption of reliance).

<sup>142</sup> *DeMarco v. Lehman Bros. Inc.*, 309 F. Supp. 2d 631 (S.D.N.Y. 2004).

reports contained negative information as well as positive, plaintiffs were adequately informed of the risks.<sup>143</sup> The court made short shrift of this contention, saying that the report's award of the firm's highest possible rating to the stock was "tantamount to a statement that the reader of the reports should discount the skeptical language."<sup>144</sup> Similarly, Judge Cote found the "bespeaks caution" doctrine inapplicable in *In re Worldcom Sec. Litig.*<sup>145</sup>

On the other hand, Senior District Judge Pollack ruled that the plaintiffs failed to overcome the "bespeaks caution" doctrine because the reports written by Merrill Lynch's star Internet analyst, Henry Blodgett, contained sufficient specific risk-related disclosures, effectively neutralizing the stock's high rating.<sup>146</sup> While Blodgett's reports did contain repeated references to the stocks' volatility, it is unclear whether they really differed substantively from those being issued by other analyst bias defendants at the time. What is clear is that Judge Pollack was manifestly unwilling to permit plaintiffs in any of the Merrill cases to proceed beyond the dismissal stage, which result was achieved not only with his "bespeaks caution" ruling but also by way of his reasoning on other elements of their cases, most notably reliance and loss causation.

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<sup>143</sup> *Id.* at 635.

<sup>144</sup> *Id.* at 634. The court also forecast that the defendants' "highest 'buy'" recommendation could be viewed as "completely overwhelm[ing]" any contrary cautions. *Id.* at 635.

<sup>145</sup> 294 F. Supp. 2d 392, 427 (S.D.N.Y. 2003) (finding that boiler-plate cautionary language does not negate plaintiffs' allegations that Grubman's opinions were not rendered in good faith). Judge Cote quotes the vivid, now-familiar analogy from *In re Prudential Sec. Inc. Ltd Partnership Litig.*, 930 F. Supp. 68 (S.D.N.Y. 1996): "The doctrine of bespeaks caution provides no protection to someone who warns his hiking companion to walk slowly because there might be a ditch ahead when he knows with near certainty that the Grand Canyon lies one foot away." *Id.* at 72.

<sup>146</sup> *In re Merrill Lynch Research Reports Sec. Litig.* (re 24/7 RealMedia and Interliant), 273 F. Supp. 2d 351, 377-378 (S.D.N.Y. 2003); *In re Merrill Lynch Research Reports Sec. Litig.* (re Global Technology Fund), 272 F. Supp. 2d 243, 247 (S.D.N.Y. 2003) (same ruling in context of alleged violations of Section 11 and 12 of 1934 Act).

Compelling existing precedent on the subject of materiality and duty to disclose aside, it is important to recall that the question is usually one of fact for the factfinder.<sup>147</sup> Given this, the precise allegations involved, and/or the procedural status of the cases, materiality appears – in most courts considering analyst bias cases – to be either a matter to be resolved at a later date or a foregone conclusion.<sup>148</sup> Yet bigger questions are presented by the remaining elements of the 10(b) case: scienter, reliance, and causation, which are discussed in ensuing sections.

#### **Section IV – Scienter**

Nearly thirty years ago, in *Hochfelder v. Hochfelder*,<sup>149</sup> the Supreme Court made it clear that scienter is a necessary element of a 10(b) claim. In that case, the Court defined the necessary scienter as “a mental state embracing intent to deceive, manipulate, or defraud.”<sup>150</sup> In the years since, courts have struggled to define what level of conduct, if any, short of intentional might qualify. The *Hochfelder* Court expressly left open the question whether reckless conduct will suffice, noting only that: “in certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act.”<sup>151</sup> By the time the Private Securities Litigation Reform

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<sup>147</sup> Whether a statement is material is usually a question for the fact finder. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976). Hence, a complaint should not be dismissed on the grounds that the alleged misstatements or omissions are immaterial unless they are “so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance.” *Ganino v. Citizens Util. Co.*, 228 F.3d 154, 162 (2d Cir. 2000) *quoting* *Goldman v. Belden*, 754 F.2d 1059, 1067 (2d Cir. 1985).

<sup>148</sup> *See, e.g.*, *Fogarazzo v. Lehman Bros.*, 03 Civ. 5194 (SAS), 2004 U.S. Dist. LEXIS 9193 (S.D.N.Y. May 21, 2004) (defendants asserting loss causation and time bar as bases for dismissal of complaint at pleading stage); *but see* *DeMarco v. Robertson Stephens*, at \*16 (disposing of the materiality issue favorably to plaintiffs by ruling on motion to dismiss that “it is entirely reasonable that investors would consider analyst recommendations as part of the ‘total mix’ of information available when making purchases.”).

<sup>149</sup> 425 U.S. 185 (1976).

<sup>150</sup> *Id.* at 194 n.12. *See generally* 8 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 3664 (3d ed. 1991); Elaine E. Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5: Ernst & Ernst v. Hochfelder*, 29 STAN. L. REV. 213, 218 (1977).

<sup>151</sup> 425 U.S. at 194 n.12.



Act was passed in 1995, most of the circuits had determined that proof of recklessness was satisfactory as an alternative to conscious or intentional conduct.<sup>152</sup>

The PSLRA then muddied the waters by heightening the pleading standard for the required state of mind in a 10(b) action.<sup>153</sup> Rather than alleging facts sufficient to enable a court simply to draw an inference or even a reasonable inference of recklessness or conscious misbehavior on the part of the defendant, plaintiffs are now required to allege – with particularity – sufficient facts to permit the court to draw a *strong* inference of the required scienter.<sup>154</sup> The PSLRA’s particularity provision thus requires plaintiffs to have a larger quantum of proof at their disposal before filing suit, not just to obtain it later in connection with the discovery process.<sup>155</sup> In this way, the PSLRA sought to reduce frivolous strike suits<sup>156</sup> against securities issuers.<sup>157</sup>

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<sup>152</sup> See *Cook v. Avien, Inc.*, 573 F.2d 685, 692 (1st Cir. 1978); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 46 (2d Cir. 1978); *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 193 (3d Cir. 1981); *Broad v. Rockwell Int’l Corp.*, 642 F.2d 929, 961-62 (5th Cir. 1981) (en banc); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1023-25 (6th Cir. 1979); *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1044 (7th Cir. 1977); *Stokes v. Lokken*, 644 F.2d 779, 783 (8th Cir., 1981); *Nelson v. Serwold*, 576 F.2d 1332, 1338 (9th Cir. 1978); *Hackbart v. Holmes*, 675 F.2d 1114, 1117-18 (10th Cir. 1982); *McDonald v. Alan Bush Brokerage Co.*, 863 F.2d 809, 814 (11th Cir. 1989); *Dirks v. SEC*, 220 U.S. App. D.C. 309, 681 F.2d 824, 844 n.27 (D.C. Cir. 1982), *rev’d on other grounds*, 463 U.S. 646 (1983).

Though the Fourth Circuit had not explicitly found recklessness to be sufficient, district courts in that circuit had so held. See *In re EPIC Mortgage Ins. Litigation*, 701 F.Supp. 1192, 1250 (E.D. Va. 1988) (citing cases), *aff’d in part, rev’d in part on other grounds sub nom.* *Foremost Guar. Corp. v. Meritor Sav. Bank*, 910 F.2d 118 (4th Cir. 1990).

<sup>153</sup> For a more detailed discussion of the PSLRA’s heightened pleading standards, see Ann Morales Olazábal, *The Search for Middle Ground: Towards a Harmonized Interpretation of the Private Securities Litigation Reform Act’s New Pleading Standards*, 6 STAN. J. L. BUS. & FIN. 153, 154-189 (Spring 2001).

<sup>154</sup> The relevant provision of the PSLRA reads as follows:

In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

15 U.S.C. § 78u-4(b)(2).

<sup>155</sup> The PSLRA provides for a mandatory discovery stay as follows: “...all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party. 15 U.S.C. §78u-4(b)(3)(B). Courts have generally observed this mandate as regards typical discovery. See, e.g., *In re Merrill Lynch Research Reports Sec. Litig.*, No. 02 MDL 1484 (MP), 2004 U.S. Dist. LEXIS 2215 (February 18, 2004) (denying plaintiffs discovery). A split of sorts appears to have developed among the district courts over whether this section prohibits discovery, prior to a motion to

The question thus has become not so much whether recklessness will suffice,<sup>158</sup> but what types of particularized fact allegations and what level of detail are necessary to enable the court to draw the required strong inference of scienter.<sup>159</sup> The Second Circuit has held that to satisfy PSLRA's scienter requirement, plaintiffs must allege either (a) facts showing "that defendants had both motive and opportunity to commit fraud," or (b) "facts . . . that constitute strong circumstantial evidence of conscious misbehavior or recklessness."<sup>160</sup>

Sufficient motive allegations in the Second Circuit "entail concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged."<sup>161</sup> Indeed, the court has clearly stated that motives that are generally possessed by public corporations and their directors and officers do not suffice; instead, plaintiffs must assert an actual, personal benefit to the individual defendants resulting from the

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dismiss, of documents produced to governmental entities. *Compare, e.g.,* In re Enron Corp. Sec., Derivative & Erisa Litig., 2002 WL 31845114 (S.D. Tex. Aug. 16, 2002) (permitting partial lifting of stay with regard to documents made available to governmental entities because burden would be slight and documents had already been made available outside the litigation) *with* In re Vivendi Universal, S.A. Sec. Litig., 2003 WL 21035383 (S.D.N.Y. May 6, 2003) (holding that there is no exception for documents previously produced to governmental entities and plaintiffs failed to establish undue prejudice or need to preserve evidence under statute); In re HealthSouth Sec. Litig., CV-03-BE-1500-S, (N.D. Ala., Dec. 8, 2003) (holding that to allow the plaintiffs to use documents previously produced to Congress would "creat[e] an absurd result in direct contravention of Congress' intent to protect defendants from the possibility that documents produced to governmental entities may be used by the plaintiffs in formulating a complaint or in opposing a motion to dismiss.")

<sup>156</sup> Strike suits have been defined as: "Shareholder derivative actions begun with the hope of winning large attorney fees or private settlements, and with no intention of benefitting corporation on behalf of which suit it is theoretically brought." BLACK'S LAW DICTIONARY, Revised 4th Ed. (1968).

<sup>157</sup> *See, e.g.,* In re Silicon Graphics, Inc. Sec. Litig., 183 F.3d 970, 985, 988 (9th Cir. 1999) (remarking that PSLRA was designed to deter "fishing expeditions") *citing* Medhekar v. U. S. District Ct., 99 F.3d 325, 328 (9th Cir. 1996) ("holding that Congress intended for complaints under the PSLRA to stand or fall based on the actual knowledge of the plaintiffs rather than information produced by the defendants after the action has been filed.")

<sup>158</sup> At first the PSLRA's pleading standards threw the required state of mind into some flux, with the question of the necessary degree of recklessness being at the forefront, but it appears that a middle ground ultimately was reached. Olazábal, *supra* note \*.

<sup>159</sup> *See, e.g.,* Novak v. Kasaks, 216 F.3d 300, 311 (2d Cir. 2000).

<sup>160</sup> *See, e.g.,* Kalnit v. Eichler, 264 F.3d 131, 138 (2d Cir. 2001). In enacting the heightened standard, Congress "did not change the basic pleading standard for scienter in [the Second] Circuit (except by the addition of the words 'with particularity')." Novak, 216 F.3d at 310.

<sup>161</sup> Novak, 216 F.3d at 307 (quoting Shields, 25 F.3d at 1130).

fraud.<sup>162</sup> More specifically, the Second Circuit has found that motive and opportunity were sufficiently pleaded where the defendants' misrepresentations were accompanied by insider trading, because "the allegation supports the inference that [defendant] withheld disclosures that would depress his stock until he had profitably sold his shares."<sup>163</sup> Similarly, it has concluded that a plaintiff sufficiently alleged motive where the purportedly fraudulent statements were quickly followed by the defendant's sale of 80% of his holdings at a substantial profit.<sup>164</sup> And, where an issuer failed to disclose information, artificially inflating its stock price with an eye toward using stock to make an acquisition, along with insider trading allegations, scienter had been adequately pleaded.<sup>165</sup>

As regards the other possible method of adequately pleading scienter, facts constituting "strong circumstantial evidence of conscious misbehavior or recklessness," the Second Circuit uncharacteristically has referred, in *dicta* in a case called *Novak v. Kasaks*, to several categories of cases that will qualify as establishing a strong inference of the required state of mind.<sup>166</sup> These include allegations that defendants "engaged in

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<sup>162</sup> *Id.* at 307-08. *See also* *Chill v. General Electric Co.*, 101 F.3d 263, 267 (2d Cir. 1996) (rejecting as insufficient motive allegation plaintiffs' assertion that defendant sought to justify its over \$1 billion investment in a subsidiary); *Acito v. Imcera Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995) (rejecting contention that officers were motivated to inflate the value of stock to increase their executive compensation); *San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris Cos.*, 75 F.3d 801, 813 (2d Cir. 1996) (holding that defendant issuer's desire to maintain a high bond or credit rating does not qualify as sufficient motive, because this desire can be imputed to all companies); *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1130 (2d Cir. 1994) (holding that "plaintiff must do more than merely charge that executives aim to prolong the benefits of the positions they hold.")

<sup>163</sup> *Stevelman v. Alias Research, Inc.*, 174 F.3d 79, 85 (2d Cir. 1999); *Goldman v. Belden*, 754 F.2d 1059, 1070 (2d Cir. 1985).

<sup>164</sup> *In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 74-75 (2d Cir. 2001).

<sup>165</sup> *Rothman v. Gregor*, 220 F.3d 81, 94 (2d Cir. 2000) (leaving open question whether artificial price inflation alone was sufficient).

<sup>166</sup> 216 F.3d at 311.

deliberately illegal behavior,”<sup>167</sup> “knew facts or had access to information suggesting their public statements were inaccurate,”<sup>168</sup> “failed to check information they had a duty to monitor,” or “ignored obvious signs of fraud.”<sup>169</sup> In addition to providing this positive guidance, the *Novak* court also set out several important limitations on what types of facts will not support a strong inference of scienter. Thus, though issuers are responsible for disclosure of material facts reasonably available to them, they “need not be clairvoyant” or anticipate future events.<sup>170</sup> Nor must corporate officers present an overly gloomy view of the issuer’s prospects.<sup>171</sup> Further, and of particular interest in this context, the court in *Novak* explicitly warned that:

...there are limits to the scope of liability for failure adequately to monitor the allegedly fraudulent behavior of others. Thus, the failure of a non-fiduciary accounting firm to identify problems with the defendant-company’s internal controls and accounting practices does not constitute reckless conduct sufficient for § 10(b) liability. Similarly, the failure of a parent company to interpret extraordinarily positive performance by its subsidiary ... as a sign of problems and thus to investigate further does not amount to recklessness under the securities laws. Finally, allegations of GAAP violations or accounting irregularities, standing alone, are insufficient to state a securities fraud claim.

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<sup>167</sup> *Id.* at 308, *citing* Simon DeBartolo Group, L.P. v. Richard E. Jacobs Group, Inc., 186 F.3d 157, 168-69 (2d Cir. 1999); Schoenbaum v. Firstbrook, 405 F.2d 215, 219 (2d Cir. 1968) (en banc).

<sup>168</sup> *Novak*, 216 F.3d at 308, *citing* Cosmas v. Hassett, 886 F.2d 8, 12 (2d Cir. 1989) and Goldman v. Belden, 754 F.2d at 1063, 1070.

<sup>169</sup> 216 F.3d at 308, *citing* Rolf v. Blyth, Eastman Dillon & Co., Inc., 570 F.2d 38, 47-48 (2d Cir. 1978); SEC v. McNulty, 137 F.3d 732, 741 (2d Cir. 1998).

<sup>170</sup> 216 F.3d at 309, *citing* Denny v. Barber, 576 F.2d 465, 470 (2d Cir. 1978); Acito, 47 F.3d at 53.

<sup>171</sup> 216 F.3d at 309, *citing* Stevelman, 174 F.3d at 85; Shields, 25 F.3d at 1129-30.

Only where such allegations are coupled with evidence of “corresponding fraudulent intent,” might they be sufficient.<sup>172</sup>

Given the foregoing, whether a given plaintiff can allege facts sufficient to support the necessary inference of scienter is a deeply fact intensive inquiry.<sup>173</sup>

#### **(a) Existing Precedent**

A number of cases preceding the recent spate of analyst bias cases looked at the types of facts that might support a finding of scienter where an analyst’s report was alleged to be fraudulent. A study in the fact intensive nature of the scienter inquiry is Judge Folsom’s ruling on the defendant brokerage firms’ motion to dismiss the plaintiffs’ Fourth Amended Complaint in the case of *McNamara v. Bre-X Minerals, Ltd.*<sup>174</sup> following one of the largest mining discovery frauds ever perpetrated on investors,<sup>175</sup> a class action suit was brought against, *inter alia*, analysts and three broker dealer firms, J.P. Morgan, Nesbitt Burns (of Canada), and Lehman Brothers, alleging they disseminated false and misleading statements and research reports on the mining exploration company called Bre-X. Neither of the former defendants was able to

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<sup>172</sup> 216 F.3d at 309, *citing* Decker v. Massey-Ferguson, Ltd., 681 F.2d 111, 120 (2d Cir. 1982); Chill, 101 F.3d at 269-70; Stevelman, 174 F.3d at 84.

<sup>173</sup> *See, e.g.,* Kalnit, 264 F.3d at 142 (citation omitted) (calling scienter a “highly fact based inquiry”); Bruce A. Mann, *Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45 N.Y.U. L. REV. 1206, 1207 (1970) (demonstrating that courts “feign” consistent standards, while deciding cases based on their individual facts).

<sup>174</sup> 197 F. Supp. 2d 622 (E.D. Texas 2001).

<sup>175</sup> A number of books have been written about the infamous Indonesian gold scandal. *See, e.g.,* Jennifer Wells, *BRE-X: THE INSIDE STORY OF THE WORLD’S BIGGEST MINING SCAM* (Texere, 1999); Diane Francis, *BRE-X: THE INSIDE STORY* (Key Porter Books, 1998); Douglas Goold & Andrew Willis, *THE BRE-X FRAUD* (McLelland & Stewart, 1997); James Whyte & Vivian Danielson, *BRE-X: GOLD TODAY, GONE TOMORROW* (Northern Miner Pr. Ltd., 1997).

extricate itself from the suit at the 12(b)(6) stage; the latter defendant was.<sup>176</sup> The difference, of course, was in the facts pled against each of the analysts and firms.

Nesbitt Burns's analyst, Bianchini, was a trained geologist and allegedly Canada's "superstar" gold analyst. He was alleged to have owned a million or more shares of the inexperienced mining exploration company's stock and, as one of Bre-X's biggest "cheerleaders" in the Canadian market, to have had unique inside access to Bre-X insiders.<sup>177</sup> Privy to various reports that should have raised serious red flags about the existence of any gold at the site Bre-X eventually claimed would yield more than 200 million ounces of gold (making it the largest gold deposit in the world),<sup>178</sup> Bianchini had both the expertise and information that should have put him on notice of the probability of so-called "salted" samples.<sup>179</sup> Instead, Bianchini vouched for Bre-X's management and consistently reported gold reserves in excess even of what the company was touting. Ultimately, when Bre-X's unconventional assay techniques were made public, he also vowed to defend the company and to do damage control by calling institutional investors personally to push its stock.<sup>180</sup>

Further, while the fact was not specifically included in the court's discussion against the firm, Nesbitt Burns was the Canadian investment bank and broker dealer that had also acted as one of the underwriters for Bre-X stock issuance.<sup>181</sup> Unlike many of today's analyst bias cases, no conflict of interest arising from that fact was apparently alleged. Bianchini's ownership interest in the stock and the collusive nature of the

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<sup>176</sup> *Id.* at 683, 693, 697. No appellate review ensued, as the suit against J.P. Morgan, Nesbitt Burns, and Lehman Brothers subsequently was settled. *See* *McNamara v. Bre-X Minerals, Ltd.*, No. 5:97-CV-159, 2002 U.S. Dist. LEXIS 26465 (E.D. Tex., July 3, 2002).

<sup>177</sup> *Id.* at 691-693.

<sup>178</sup> *Id.* at 677.

<sup>179</sup> *Id.* at 635.

<sup>180</sup> *Id.* at 635, 637, 640.

<sup>181</sup> *Id.* at 635.

relationship between the analyst and the researched company no doubt drove the court's straightforward conclusion that the facts alleged gave rise to a "strong inference that Bianchini was consciously aware of a substantial risk that [the gold discovery in Indonesia] was a fraud."<sup>182</sup> As such, the suit was permitted to proceed beyond the dismissal stage.

The facts against J.P. Morgan were similarly dooming. J.P. Morgan was the American investment bank hired by Bre-X as a "financial advisor" to assist with negotiations with potential partners for a joint venture to develop the purported gold mine.<sup>183</sup> As such, Morgan stood to earn millions of dollars in fees if a joint venture agreement could be consummated.<sup>184</sup> After its engagement, J.P. Morgan and its geologist analyst/investment banker, Doug McIntosh,<sup>185</sup> was made privy to substantial inside technical data.<sup>186</sup> In an effort to put the best face on Bre-X as a possible joint venture partner, J.P. Morgan discussed additional technical data with third party mining engineers that had previously analyzed Bre-X's gold resource estimates and also reviewed reports that had been prepared by a potential joint venture partner.<sup>187</sup> After reviewing all the data, J.P. Morgan decided which resource estimates ought to be published, aggressively spinning the available information.<sup>188</sup> J. P. Morgan also commissioned an independent engineer's report, which suggested changes in the assaying techniques to confirm the resource estimates, all of which suggestions Bre-X and J.P. Morgan ignored.<sup>189</sup>

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<sup>182</sup> *Id.* at 693.

<sup>183</sup> *Id.* at 629.

<sup>184</sup> *Id.* at 646.

<sup>185</sup> *McNamara v. Bre-X Minerals, Ltd.*, 57 F. Supp. 2d 396, 422 (E.D. Texas, 1999) (opinion dismissing Second Amended Complaint without prejudice, as against all brokerage defendants)

<sup>186</sup> *Id.* at 646-647.

<sup>187</sup> *Id.* at 648.

<sup>188</sup> *Id.*

<sup>189</sup> *Id.* at 650-651.

Nonetheless, J.P. Morgan's analyst/investment banker glowingly discussed Bre-X's prospects in a conference call with other stock analysts and reporters.<sup>190</sup> Later, J.P. Morgan was alleged to have been made privy to another independent analysis of Bre-X's resource estimates and assaying results, which indicated unequivocally that there was very little or no gold at Bre-X's mining site. In response, J. P. Morgan apparently advised Bre-X to refuse any further concessions on due diligence at the mining site in its joint venture negotiations.<sup>191</sup> These facts, in the court's mind, gave rise to a strong inference of the necessary scienter on the part of J.P. Morgan. Its motion to dismiss, therefore, was denied.<sup>192</sup>

Lehman Brothers's fate was different. Lehman's mining analyst, McConvey, was neither an engineer nor geologist, nor was he in any way connected to Bre-X insiders, though coincidentally he had for six years acted as comptroller of Bre-X's chosen joint venture partner, and thus he was familiar in a rudimentary way with the science and technology of the gold mining industry.<sup>193</sup> The primary allegation against Lehman was that its analyst, who issued positive research reports and recommendations on Bre-X, read and summarized in one of his reports an outside expert's report on the mine site that allegedly raised red flags about the veracity of Bre-X's gold claims. But belying plaintiffs' contention that this indicated his complicity, the court pointed to the fact that McConvey repeated every fact in his report that allegedly "should have" raised a red flag. This, the court felt, negated any conscious wrongdoing.<sup>194</sup> Thus, it held that at most

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<sup>190</sup> *Id.* at 679-680.

<sup>191</sup> *Id.* at 682.

<sup>192</sup> *Id.* at 683.

<sup>193</sup> *Id.* at 694-695.

<sup>194</sup> *Id.* at 696.



Lehman was negligent – not enough to support a 10b claim – and dismissed the suit against it.<sup>195</sup>

At least as far as the case against the analysts and broker dealers, the Bre-X opinion focused primarily on their scienter or lack thereof. As such it stands primarily for the proposition that a class action suit may rise or fall based on the level of access to insiders and inside information that a given analyst had. And, it stands to reason that that the more closely aligned an analyst's financial interests are with those of the issuer, the more likely he or she will have participated in the fraud or at least knowingly advanced or concealed it.

The analyst Smith's scienter was also at issue in the *Cybermedia* case.<sup>196</sup> Recall that there the plaintiffs had alleged that Smith plugged AOP stock as a "double your money" investment on a CNN appearance. Plaintiffs' bases for alleging a strong inference of scienter on Smith's part were his potential increased compensation package if AOP's stock price were to go up, and the fact he allegedly had "access to inaccurate data, which he failed to verify prior to touting AOP on television."<sup>197</sup> The court found

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<sup>195</sup> *Id.* at 697.

<sup>196</sup> 183 F.Supp.2d 559 (E.D.N.Y. 2002). The court in *Cooper*, discussed *supra* in text accompanying notes \*-\*, had also addressed the sufficiency of facts pled giving rise to the necessary element of scienter. However, as the case was decided under pre-PSLRA pleading standards, its cursorily analyzed holding in that regard is inapposite to today's cases. *Id.* at 628. The *Cooper* court found that allegations of false statements and of the conditions in existence at the issuer at the time, as well as an allegation that the investment banks' "close relationship" with the issuer gave them access to inside information, were sufficient to give rise to an inference that the analyst defendants knew their reports were false, satisfying scienter pleading for purposes of a motion to dismiss. *Id.* Today, *particular* facts giving rise to a strong, not just reasonable, inference of scienter would need to be pled for plaintiffs to survive a motion to dismiss. 15 U.S.C. § 78u-4(b)(2).

<sup>197</sup> *Id.* at 574. The opinion does not further elaborate on the source of that information or the level of specificity with which such allegations were made.

that the latter fact alone created a strong inference of scienter on Smith's part, citing one of the scienter criteria established in the Second Circuit's *Novak v. Kasaks*.<sup>198</sup>

Cases against non-analysts purporting to give independent stock advice also seem to support the notion that the current analyst bias cases can satisfy the scienter element of a 10b claim. For example, where one publishes ostensibly independent research that is in effect "bought and paid for" by the issuer, failure to disclose that fact has been held to support a finding of intentional or at best extremely reckless behavior, giving rise to 10(b) liability.<sup>199</sup> Likewise, intent to profit from the price inflation likely to be caused by one's recommendation also has been held to establish at least a triable issue with regard to scienter.<sup>200</sup> Knowing violations of industry regulations may also permit an inference of recklessness.<sup>201</sup>

#### **(b) Pending Analyst Bias Cases**

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<sup>198</sup> *Id.* at 574, quoting *Novak* for the proposition that "[a] strong inference arises where the complaint alleges that 'defendants: ... (3) knew facts or had access to information suggesting that their public statements were not accurate ....'" *Id.* The *Novak* case also articulates the rule that any such contrary information must be identified with particularity in the complaint. 216 F.3d at 309. There was no discussion in *Cybermedia* of whether the particularity hurdle set by the PSLRA was also met.

<sup>199</sup> *See, e.g., SEC v. Gorsek*, 222 F. Supp. 2d 1099 (C.D. Ill. 2001) (granting summary judgment in favor of plaintiffs on issue of defendants' liability under both Section 17(b) and 10(b) of the Securities Exchange Act).

<sup>200</sup> *See Zweig v. Hearst*, 594 F.2d 1261, 1271 (9<sup>th</sup> Cir. 1979). Of course this case predates the heightened pleading standards established by the PSLRA, but its rationale is still sound assuming sufficient particularity of facts is present in the complaint: "[defendant columnist] knew the material facts he failed to reveal. Moreover, there is at the very least a triable issue of fact as to whether [he] intended to benefit from the column, from which he intentionally omitted any mention of his financial interests [in the stock he glowingly recommended]." Further supporting the scienter allegations in that case was the fact that the defendant made it a practice to purchase the stocks he would recommend prior to publishing his columns, often at prices below market directly from the issuers, which were small regional companies, and then trade on the inflated prices his column created. *Id.* at 1265.

<sup>201</sup> *See, e.g., Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 273 (3d Cir. 1998) (re: duty of best execution); *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1031 (2d Cir. 1993) (re: suitability rule). A pre-PSLRA case from the Ninth Circuit also holds that breach of a broker's duty to make suitability recommendations is a "reckless violation of Section 10(b)," but given the Ninth Circuit's much more lax pleading standards at the time, the case is of questionable continuing vitality. *Vucinich v. Paine, Webber, Jackson, & Curtis, Inc.*, 803 F.2d 454, 460 (9<sup>th</sup> Cir. 1986).

Typical of the pending analyst bias cases is *DeMarco v. Robertson Stephens, Inc.*,<sup>202</sup> in which the defendant brokerage is alleged to have owned a substantial number of shares in the company researched. Plaintiffs alleged that the defendant analysts' reports recommended "buy" during the lockup period and throughout the time the broker-dealer unloaded its shares. District Judge Lynch found these allegations adequate to support either prong of the traditional Second Circuit scienter test.<sup>203</sup> Motive, the court found, was properly alleged by facts showing the brokerage's ownership of the shares, and opportunity via the use of the research reports to encourage investors to purchase shares at prices defendant believed to be inflated.<sup>204</sup> Alternatively or in addition, Judge Lynch felt that a strong inference of conscious misbehavior or recklessness was sufficiently alleged by identifying the analyst's contrary internal sell recommendation, bookended closely in time as it was by his positive publicly disseminated research reports and buy recommendations.<sup>205</sup>

Judge Scheindlin's ruling in *Fogarazzo*<sup>206</sup> was similar. In that case, she found two concrete personal benefits supporting motive had been alleged: (1) artificial price inflation to support defendant's own sales of the stock recommended, and (2) "remarkable coincidences" highly suggestive of a *quid pro quo* between defendants and securities issuers of positive reports for investment banking business.<sup>207</sup> She also found more broadly that allegations the defendants "were issuing recommendations that were contrary to their true evaluations of the relevant securities or were otherwise tainted by

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<sup>202</sup> No. 03 Civ. 590 (GEL), 2004 U.S. Dist. LEXIS 265 (S.D.N.Y. January 8, 2004).

<sup>203</sup> DeMarco at \*17, *citing* Acito v. IMCERA Group, Inc., 47 F.3d 47, 52 (2d Cir. 1995)(*quoting* Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124 (2d Cir. 1994)), and *In re Worldcom*, 2003 WL 21219049, at \*16-17.

<sup>204</sup> DeMarco at \*13-15

<sup>205</sup> *Id.*

<sup>206</sup> No. 03 Civ. 5194 (SAS), 2004 U.S. Dist. LEXIS 9193 (S.D.N.Y. May 21, 2004).

<sup>207</sup> *Id.* at \*60-61.

conflicts of interest” constituted strong circumstantial evidence of conscious misbehavior.<sup>208</sup> District Judge Cote’s ruling in *Worldcom*, with facts strongly analogous to the high level of entanglement between the issuer and the Nesbitt Burns defendants in *Bre-X*, likewise found sufficient both motive and opportunity allegations and claims suggesting conscious misbehavior or recklessness.<sup>209</sup>

Another court took a little different tack when presented with direct evidence supporting the plaintiff’s contention that the analyst did not truly hold the opinion he disseminated. In *DeMarco v. Lehman Brothers*, District Judge Rakoff viewed the contrary opinion contained in the defendant’s emails as sufficient to establish a prima facie case of both falsity and scienter: “... the stark difference between what Stanek was effectively recommending to readers of his reports, i.e., “buy,” and what he was effectively recommending to preferred customers in his emails, i.e., “sell,” supports a reasonable inference of an intent to mislead and defraud the former.”<sup>210</sup> Despite the rather unfortunate reference to the old standard for pleading scienter (facts supporting a “reasonable inference” rather than “strong inference” of the requisite state of mind), the case nonetheless appear to return the correct result.<sup>211</sup>

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<sup>208</sup> *Id.* at \*58.

<sup>209</sup> 294 F. Supp. 2d 392, 425-426 (S.D.N.Y. 2003)

<sup>210</sup> *Id.* at 7; *see also* Podany v. Robertson Stephens, Inc., 2004 U.S. Dist. LEXIS 2290, \*20 (S.D.N.Y. February 10, 2004).

<sup>211</sup> *See also* Newby v. Enron (In Re Enron Corp. Sec., Derivative & “ERISA” Litig.), MDL 1446, 2003 U.S. Dist. LEXIS 25037 (S. D. Texas, November 12, 2003) (denying motion to dismiss and finding that plaintiffs had sufficiently pleaded scienter in case alleging that Enron insiders on the one hand and broker-dealer UBS Warburg and its analyst Ron Barone and retail division on the other, had a cozy and conflicted relationship sufficient to establish a “strong inference of severe recklessness,” despite reciting that defendant analyst and broker-dealer “knew or should have known” about deteriorating financial condition at Enron).

Predictably, Senior Judge Pollack has found to the contrary. In one of the *Merrill Lynch* cases before him,<sup>212</sup> Judge Pollack rejected plaintiffs' contention that defendants' "buy" and "accumulate" recommendations (predicting 20% and 10% price increases in the ensuing 12 months) were reckless. Instead, he felt the defendants' conduct fell directly within *Novak*'s proscription against liability for failure to "anticipate[ ] future events and [make] certain disclosures earlier than they actually did."<sup>213</sup> Moreover, in Judge Pollack's view, the plaintiffs failed to allege compelling facts regarding motive and opportunity to commit fraud. He found the broker-dealers' effort to attract investment banking business and the analyst's personal motive to increase his bonus compensation insufficient as a matter of law, calling these examples of motives held by many, for which there is no liability.<sup>214</sup>

Judge Pollack's premise that bubble economy investors were "gamblers" and his opinion that the bursting of the bubble was a separate and intervening cause of investors' losses (apparently not contributed to by defendants in these cases), render his view on scienter unsurprising. The remaining trial judges in the Southern District of New York have found, in the more serious and factually supported analyst bias cases, sufficient allegations to establish a triable issue with regard to scienter. The author does not disagree.

## **Section V – Reliance**

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<sup>212</sup> In re Merrill Lynch Research Reports Sec. Litig. (eToys.com), 289 F. Sup. 2d 416 (S.D.N.Y. 2003).

<sup>213</sup> *Id.* at 427-428.

<sup>214</sup> *Id.* at 428, citing *Zucker v. Sasaki*, 963 F. Supp. 301, 308 (S.D.N.Y. 1997) for the proposition that "Receipt of compensation and the maintenance of a profitable professional business relationship . . . does not constitute a sufficient motive for purposes of pleading scienter," and *Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995) for the proposition that "incentive compensation is not a basis for allegations of fraud."

In a 10(b) claim, the reliance element “is a *causa sine qua non*, a type of ‘but for’ requirement: had the investor known the truth he would not have acted.”<sup>215</sup> Proof of reliance, also sometimes called “transaction causation,” depends on the type of case.<sup>216</sup> Establishing individual reliance is not much of an obstacle in cases involving plaintiffs who dealt directly with the defendant(s) and who considered a misrepresented fact when entering into the securities transaction. But today not all 10(b) cases involve direct reliance by individual plaintiffs. Indeed, there are two other basic fact scenarios in which a presumption of reliance is permitted. First, the *Affiliated Ute* presumption, where the plaintiffs’ claims are based upon material omissions,<sup>217</sup> and second, the fraud-on-the-market doctrine, which presumes reliance where the subject securities transactions involved not direct “face to face” dealings with the defendants, but instead are made in

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<sup>215</sup> *Huddleston v. Herman & McLean*, 640 F. 2d 534, 549 (5<sup>th</sup> Cir. 1981).

<sup>216</sup> The Fifth Circuit described the interplay between reliance and transaction causation as follows: “Courts sometimes consider the reliance component of the Rule 10b-5 action to be a part of the causation element. 5 A. Jacobs, *The Impact of Rule 10b-5 § 64.01(a)*, at 3-221 (Supp.1980). In this context, the term ‘transaction causation’ is used to describe the requirement that the defendant’s fraud must precipitate the investment decision. Reliance is necessarily closely related to ‘transaction causation.’” *Huddleston*, 640 F. 2d at 549 n.24.

<sup>217</sup> *Affiliated Ute*, cited in *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 174 (3d Cir 2001) in the context of class certification motion in a 10(b) case against a broker-dealer who was alleged to have omitted to disclose a practice that resulted in higher than necessary prices to its customers. In holding that the burden of rebutting the presumption of reliance was properly on defendants, the *Newton* court also referred the reader to the following analogous cases regarding the *Affiliated Ute* presumption of reliance in material omission cases: “*Eisenberg v. Gagnon*, 766 F.2d 770, 786-87 (3d Cir. 1985) (holding individual questions of reliance in securities class action involving investment in tax shelters did not preclude certification). ... *Grandon v. Merrill Lynch & Co., Inc.*, 147 F.3d 184, 190 (2d Cir. 1998) (‘A broker-dealer commits fraud (in violation of § 10(b) and Rule 10b-5) by charging customers excessive markups without proper disclosure.’); *Bank of Lexington & Trust Co. v. Vining-Sparks Sec., Inc.*, 959 F.2d 606, 613 (6th Cir. 1992) (‘The failure to disclose exorbitant mark-ups violates section 78j(b) and Rule 10b-5.’); *Angelastro v. Prudential-Bache Sec., Inc.*, 764 F.2d 939, 942-46 (3d Cir. 1985) (reliance does not bar private securities fraud action involving nondisclosure of fraudulent credit terms on margin accounts); *Ettinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 122 F.R.D. 177, 180, 182 (E.D. Pa. 1988) (reliance not an issue in securities class action alleging securities dealer failed to disclose improper markups on bonds).” *Id.* at 175.

reliance on the impersonal market to establish the value of the security in which they transacted.<sup>218</sup>

Both of the reliance presumptions may arise in the analyst bias cases. The *Affiliated Ute* presumption, for example, was held expressly to apply in the *WorldCom* suit, where much of the plaintiffs' claim is based upon allegations of a so-called "illicit quid pro quo relationship" between the broker-dealer and analyst, Salomon Smith Barney and Jack Grubman, on the one hand, and WorldCom and its executives, particularly Bernard Ebbers, on the other.<sup>219</sup> In assessing the applicability of the fraud-on-the-market theory to the suit, Judge Denise Cote's order certifying the class in that case characterizes the case as one involving not only misrepresentations (in the form of false opinions) but also omissions, to which the *Affiliated Ute* presumption will apply.<sup>220</sup> This was not a controversial finding. However, defendants in the analyst bias cases have strenuously argued in false opinion cases that the other reliance presumption, the fraud-on-the-market theory, does not apply to them. A brief historical survey of that doctrine, thus, is in order.

Since at least 1975, plaintiffs relying on the fraud-on-the-market theory have been able to bring securities fraud class actions even though they may not have heard or read the offending statement or document in which misrepresentations or omissions were allegedly made.<sup>221</sup> In lieu of alleging and proving direct individual reliance, plaintiffs can assert the "fraud-on-the-market" theory of reliance and transaction causation by

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<sup>218</sup> *Basic Inc.*, 485 U.S. at 241-42; *Semerenko*, 223 F.3d at 178; *In re Burlington Coat Factory*, 114 F.3d at 1419 n.8.

<sup>219</sup> *In re WorldCom, Inc. Sec. Litig.*, 219 F.R.D. 267, 277 (S.D.N.Y. 2003).

<sup>220</sup> *Id.* at 298, 301.

<sup>221</sup> The Ninth Circuit Court of Appeals was the first to expressly recognize the fraud-on-the-market theory. *Blackie v. Barrack*, 524 F.2d 891 (9<sup>th</sup> Cir. 1975). The Second Circuit did so in 1981. *Panzirer v. Wolf*, 663 F.2d 365, 368 (2d Cir. 1981). See also Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 590 (1975) (discussing *Affiliated Ute*'s reliance presumption where omitted information is material, and the then incipient fraud-on the-market theory).

alleging the materiality of the subject information.<sup>222</sup> Sanctioned by the U.S. Supreme Court in 1988 in the case of *Basic v. Levinson*,<sup>223</sup> the theory is

based on the hypothesis that, in an open and developed securities market the price of a company's stock is determined by the available material information regarding the company and its business ... Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.<sup>224</sup>

In *Basic*, the Court provided very little guidance with regard to how the presumption is to be established beyond validating its use in securities fraud class action cases involving shares that "were traded on an efficient market."<sup>225</sup> As a result, there has been inconsistent application thereof in the lower courts.<sup>226</sup> The *Basic* Court did make clear, however, that the presumption of reliance may be rebutted by "any showing that severs the link between the alleged misrepresentation and... the price received (or paid) by the plaintiff."<sup>227</sup> One possible rebuttal is the previously discussed "truth-on-the-market" defense.<sup>228</sup> However, for this defense to be adequately established, the

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<sup>222</sup> See generally Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1 (1982).

<sup>223</sup> 485 U.S. 224 (1988), quoting *Peil v. Speiser*, 806 F.2d 1154, 1160-1161 (3<sup>rd</sup> Cir. 1986).

<sup>224</sup> *Basic*, 485 U.S. at 241-42.

<sup>225</sup> *Id.* at 248 n. 27 (citing *Levinson v. Basic, Inc.*, 786 F.2d 741, 750 (6th Cir. 1986) regarding the four elements).

<sup>226</sup> See generally Paul A. Ferillo, et al., *The "Less Than" Efficient Capital Markets Hypothesis: Requiring More Proof From Plaintiffs in Fraud-on-the-Market Cases*, 78 ST. JOHN'S L. REV. 81, 89-102 (Winter 2004) (illustrating various approaches taken by district courts to requiring proof of stock's trading in an "efficient market"); Jeffery L. Oldham, Comment, *Taking "Efficient Markets" out of the Fraud-on the-Market Doctrine after the Private Securities Litigation Reform Act*, 97 NW. U.L. REV. 995, 1014 (Winter 2003) (describing inconsistent results in district courts).

<sup>227</sup> *Basic*, 485 U.S. at 248.

<sup>228</sup> *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 167 (2d Cir. 2000); *Associated Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc.*, 3 F.3d 208, 213-14 (7th Cir. 1993); *Kaplan v. Rose*, 49 F.3d 1363, 1376 (9<sup>th</sup> Cir. 1994). Cf. *Basic*, 485 U.S. at 248 (noting that one way the presumption of reliance in a fraud-on-the-market case may be rebutted is by proving that "the 'market makers' were privy to the truth"). See generally Robert Norman Sobol, *The Benefit of the Internet: The World Wide Web and the Securities Law Doctrine of Truth-on-the-Market*, 25 IOWA J. CORP. L. 85, 90-91 (Fall 1999) (describing the truth on



defendant must establish that “corrective information ... [was] conveyed to the public ‘with a degree of intensity and credibility sufficient to counter-balance effectively any misleading information created by’ the alleged misstatements.”<sup>229</sup> At least one commentator suggests that this makes the presumption all but irrebuttable.<sup>230</sup> Most commonly, it appears that courts seem to prefer to permit this question to go to the jury.<sup>231</sup>

As the fraud-on-the-market doctrine itself is relatively new, its application in existing cases involving stock recommendations also is a somewhat novel phenomenon. Older cases tended to involve face to face transactions and therefore individual reliance. For those that involved more market wide frauds, perhaps the application of the fraud-on-the-market theory was a foregone conclusion, assuming the securities at issue were viewed as trading on efficient markets.<sup>232</sup> But criticism of the fraud-on-the-market

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the market doctrine and its evidentiary burden). See also notes n+1, n+3, *infra*. A nearly identical argument, in the form of the “bespeaks caution” doctrine, also frequently is made in an attempt to rebut a finding of materiality. See note \* and accompanying text, *supra*.

<sup>229</sup> See, e.g., *Ganino*, 228 F.3d at 167 (quoting *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1116 (9<sup>th</sup> Cir. 1989). In an extreme case, a court found that the truth was transmitted to the public with even “more credibility and neutrality than was any purported misstatement from defendants.” *White v. H.R. Block, Inc.*, 02 Civ. 2289 (MBM), 2004 U.S. Dist. LEXIS 14522, \*36-37 (S.D.N.Y., July 28, 2004) (dismissing suit where abundant facts supporting truth on the market defense defeated plaintiffs’ use of fraud-on-the-market reliance presumption).

<sup>230</sup> Elliot J. Weiss & John S. Beckerman, *Let the Money do the Mentoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L. J. 2053, 2077 (1995) (remarking that feasible possibilities for rebutting the presumption “represent null, or close to null, sets”); Andrew R. Simmonds, et al., *Dealing with Anomalies, Confusion and Contradiction in Fraud on the Market Securities Class Actions*, 81 KY. L.J. 123, 141 (1993) (noting that making the necessary showing to rebut the presumption “will be virtually impossible”). But see *In re Convergent Tech. Sec. Litig.*, 721 F. Supp. 1133, 1138-39 (N.D. Cal. 1988) (applying defense to support grant of summary judgment).

<sup>231</sup> *Ganino*, 228 F.3d at 167-68; see also *Provenz v. Miller*, 102 F.3d 1478, 1493 (9<sup>th</sup> Cir. 1996) (opining that such a finding should be made on summary judgment only if “no rational jury could find that the market was misled”). The same has proven to be true in some of the analyst bias cases in which the issue has been raised so far. See, e.g., *In re Worldcom Sec. Litig.*, 294 F. Supp. 2d 392 (quoting disclaimer language contained in analysts’ reports); *DeMarco v. Robertson Stephens*, 2004 U.S. Dist. LEXIS 265 at \*25.

<sup>232</sup> At least one commentator has opined that “since virtually all securities covered by a research analyst are traded on an efficient market, a plaintiff could sue an analyst without need to prove reliance or transaction causation.” Gross, *supra* note \*, at 673. This conclusion seems to beg the question raised by defense counsel in the analyst bias cases.

doctrine has gained some ground in recent years,<sup>233</sup> setting the stage for a number of defense arguments in the current spate of analyst bias cases.

Nonetheless, the fraud-on-the-market doctrine has been successfully asserted by a number of plaintiffs on motions to dismiss. For example, District Judge Lynch has ruled on a motion to dismiss in the *DeMarco v. Robertson Stephenson* case that there is no reason not to apply the fraud-on-the-market theory to analysts (a question perhaps left open by *Basic*, which involved alleged fraudulent statements by an issuer):

... defendants do not cite a single case holding or even suggesting that the fraud-on-the-market theory extends only to misrepresentations made by individuals presumed to possess inside knowledge. Nor do economic principles underlying the doctrine support that assertion, since efficient market theory does not exclude non-insider information from the mix of information factored into share price.

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It is not for the Court to decide, on a motion to dismiss, whether or to what extent the market functioned efficiently. These are issues of fact for trial. Accepting the facts in the complaint as true, plaintiffs have adequately pled transaction causation by alleging that fraudulent opinions published in [defendant's] research reports distorted the ... share price set by the market, and that the plaintiffs relied on the integrity of that price when purchasing [the] stock.<sup>234</sup>

This is consistent with dismissal stage rulings by District Judges Scheindlin and Cote, both of whom found that simply alleging that the market relied on the subject analyst reports could support the requirement that plaintiff allege facts showing reliance or

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<sup>233</sup> See, e.g., Oldham, *supra* note \*.

<sup>234</sup> *DeMarco v. Robertson Stephens*, 03 Civ. 590 (GEL), 2004 U.S. Dist. LEXIS 265 (S.D.N.Y. January 8, 2004) at \*21, 24.

transaction causation.<sup>235</sup> Conversely, Judge Pollack, in dismissing several of the *Merrill Lynch* cases, apparently has used the fraud-on-the-market theory as the lynchpin for his finding of plaintiffs' failure to adequately show loss causation, or alternatively in one case that the fraud-on-the-market theory is inapplicable based on a truth on-the-market kind of analysis.<sup>236</sup>

Once beyond the dismissal stage, the question is whether plaintiffs can rely on the fraud-on-the-market theory to support class certification. Perhaps the biggest debate in this regard is precisely at what point procedurally the presumption should be determined to apply. The questions of market efficiency and whether a particular analyst's report or reports affected the relevant market require a look behind the pleadings. On the one hand, the Supreme Court has cautioned that fact-intensive determinations on the merits generally should not be adjudicated at the class certification stage.<sup>237</sup> On the other hand, the presumption in securities class actions is what facilitates certification of the class, as when it applies it obviates the possibility that individual questions regarding reliance will

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<sup>235</sup> In re Initial Public Offerings Sec. Litig., 241 F. Supp. 2d 281, 377 (S.D.N.Y. 2003) (finding that efficiency of the relevant market is not to be determined at the dismissal stage, as it is a mixed question of fact and law); In re Worldcom, Inc., Sec. Litig., 294 F. Supp. 2d 392, 413 (S.D.N.Y. 2003) (holding that "at the pleading stage [assertion of the fraud-on-the-market theory] satisfies plaintiffs' burden of alleging transaction causation."

<sup>236</sup> In opinions in the 24/7 Real Media and Interliant case, and the e-Toys, Inc. (and seven others) case, Judge Pollack hinges his finding that loss causation is inadequately shown on the fact the cases allege frauds on the market. In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig., 273 F. Supp. 2d 351, 363-368 and n.24 (S.D.N.Y. 2003); In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig., 289 F. Supp. 2d 416, 422 (S.D.N.Y. 2003). Later in the 24/& Real Media and Interliant opinion, however, in a short paragraph Judge Pollack declares that the analyst reports there in contention could not have operated as a fraud on the market, since information about the conflicts of interest and deceptive rating system in alleged that case were "known to the market and were specifically disclosed in the Sector Reports." *Id.* at 375.

<sup>237</sup> *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156, 177-78 (1974) (holding that courts should not adjudicate the merits at the class certification stage). See also *Wal-Mart Stores, Inc. v. Visa USA Inc.* (In re Visa Check/MasterMoney Antitrust Litig.), 280 F.3d 124, 135 (2d Cir. 2001) (holding that class certification is not the occasion for analyzing the case on its merits).

predominate over common ones.<sup>238</sup> Given these competing notions, courts have differed with respect to their perspective on when the presumption's application should be decided.<sup>239</sup> Notably, the *Basic* opinion itself was issued in connection with class certification.<sup>240</sup> At least one other Circuit Court of Appeals has affirmed a district court's use of the presumption at the class certification stage in a 10(b) case.<sup>241</sup>

Only two of the pending analyst bias cases have reached this procedural status thus far; in both of these the analyst and broker-dealer defendants' main argument against class certification was inapplicability of the fraud-on-the-market theory to analysts' reports."<sup>242</sup> The two cases came out on opposite sides of the issue. In the *Worldcom* suit, District Judge Cote refused to engage in a battle of the experts at that procedural juncture,<sup>243</sup> and found the presumption to apply.<sup>244</sup>

The SSB Defendants argue essentially that it would be inappropriate to apply the presumption of reliance to a Section 10(b) claim brought against an analyst

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<sup>238</sup> The Eisen case does not stand for the proposition that a district judge should make class certifications solely on the basis of what is pled. In *Tel. Co. of the Southwest v. Falcon*, the Court said "sometimes it may be necessary for the [district] court to probe behind the pleadings before coming to rest on the certification question." 457 U.S. 147, 160 (1982). See also *Gariety v. Grant Thornton, LLP*, No. 03-1629, 2004 U.S. App. LEXIS 9305 (4<sup>th</sup> Cir., May 12, 2004) at \*24; *Szabo v. Bridgeport Machs., Inc.*, 249 F.3d 672, 675-76 (7<sup>th</sup> Cir. 2001).

<sup>239</sup> See Robert G. Bone & David S. Evans, *Class Certification and the Substantive Merits*, 651 DUKE L. J. 1251-1273-74 (2002) (identifying split in the courts as to whether the fraud-on-the-market presumption should be adjudicated at the class certification stage), and cases cited therein.

<sup>240</sup> *Basic*, 485 U.S. at 242, 247.

<sup>241</sup> *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154 (3<sup>rd</sup> Cir 2001) (affirming denial of class certification based on plaintiffs' failure to show any economic loss, but approving application of fraud-on-the-market presumption).

<sup>242</sup> *In re Worldcom Sec. Litig.*, 219 F.R.D. 267, 297 (S.D.N.Y. 2003); *DeMarco v. Lehman Bros.*, 03 Civ. 3470 (JSR), 03 Civ. 3705 (JSR), 03 Civ. 4511 (JSR), 2004 U.S. Dist. LEXIS 12438 (S.D.N.Y. July 6, 2004).

<sup>243</sup> *Id.* at 300 (noting that defendants treat the complaint as an expert report, and finding nonetheless that "defendants have not shown that [defense expert]'s analysis will succeed in rebutting the presumption of reliance such that it is appropriate to conclude that there will be no such presumption available at trial and that individual issues will come to predominate over common ones.")

<sup>244</sup> She also based her class certification decision as regards reliance on the fact that reliance need not be shown in omission cases. See note \* (and accompanying text?) *supra*. [Affiliated Ute presumption in *Worldcom* case.]

because statements by a non-issuer are not “likely” to affect the market price. They point out that Basic approved the presumption of reliance in that case because the presumption was consistent with common sense and probability. ... They assert that it is consistent with neither to do so here. To make this argument, the SSB Defendants ignore virtually every allegation in the lengthy Amended Complaint (as well as evidence uncovered through discovery and submitted in support of this motion). At no point in their briefs do they acknowledge Grubman's alleged role as the premier analyst in the telecommunications industry. Nothing in the defendants’ briefs addresses why Grubman was paid approximately \$ 20 million a year in compensation by SSB to be its telecommunications analyst if his analyst reports were irrelevant to the market. Nothing in the defendants’ briefs addresses why Grubman issued reports announcing that WorldCom was his favorite stock, offering the opinion that “we would be aggressive buyers at these prices,” and “strongly” reiterating his “Buy rating on WorldCom,” ... if his views were not likely to affect the decisions made by WorldCom investors. The plaintiffs have shown that it comports with both common sense and probability to apply the presumption here. The defendants may attempt to rebut the presumption at trial.<sup>245</sup>

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<sup>245</sup> *Id.* at 299. (citations and footnote omitted). Similar reasoning was employed by District Judge Lynch in his refusal to dismiss: “An underwriter like [defendant] that has a research department engaged in the business of analyzing companies in order to disseminate to the public information and opinions about specific securities clearly intends that the market take into account its recommendations to buy or sell such securities. ... It is disingenuous, to say the least, for defendants to now argue that their published purchase recommendations are somehow excluded from the information available to market actors ...” *DeMarco v. Robertson Stephens* at \*21-22.

This ruling was the subject of a petition for interlocutory appeal, which was granted by the Second Circuit in late 2003.<sup>246</sup> The SEC filed an amicus brief arguing on the side of the investors.<sup>247</sup> However, just days before the scheduled oral argument on the appeal, the SSB defendants settled out of the case and the issue eluded decision.<sup>248</sup> Nonetheless, there is something to be gleaned from the opinion granting the appeal. Though the Second Circuit refuses to articulate an evidentiary standard for application of the fraud-on-the-market presumption at the class certification stage, it does seemingly discuss with approval the Seventh Circuit's refusal to certify the class in *West v. Prudential Securities, Inc.*<sup>249</sup> where the plaintiffs failed to adduce admissible evidence that – when taken most favorably to the plaintiff – would establish prima facie entitlement to the presumption.

The *WorldCom* suit is somewhat unique in this setting, as in that case there is no dispute that there was an efficient market for WorldCom stock.<sup>250</sup> When it comes to any of the more thinly traded and volatile technology stocks that are the subject of other more typical analyst bias cases, the defense that the presumption should not apply because the stock was not traded in an efficient in market will undoubtedly have more sway,

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<sup>246</sup> *Hevesi v. Citigroup, Inc.*, 336 F.2d 70 (2d Cir. 2004) (explaining December 31, 2003 order granting interlocutory appeal).

<sup>247</sup> “Thus the Court imposed no limitation that the source of the information be the company itself. The Commission believes that applying the presumption to analysts is consistent both with economic studies showing the market effect of analyst reports and with their very purpose – providing information on which to base investment decisions.” Brief of Amicus Curiae Securities and Exchange Commission, at 10, available at [www.sec.gov/litigation/briefs/wchevesi\\_amicus.htm](http://www.sec.gov/litigation/briefs/wchevesi_amicus.htm) (Last modified 4/20/04).

<sup>248</sup> Mitchell Pacelle, *Citigroup Will Pay \$2.65 billion to Settle WorldCom Investor Suit*, WALL ST. J., May 11, 2004, at A1. A copy of the Notice of Proposed Class Action Settlement filed in the case is available at [http://slw.issproxy.com/securities\\_litigation\\_blo/files/wcomsettlement\\_notice.pdf](http://slw.issproxy.com/securities_litigation_blo/files/wcomsettlement_notice.pdf) (last viewed August 6, 2004). No other interlocutory appeal on this issue presently is pending in any of the other analyst bias cases.

<sup>249</sup> 282 F.3d 935, 940 (7<sup>th</sup> Cir. 2002) (reversing class certification order that was premised on application of the fraud-on-the-market reliance presumption in case involving artificial price inflation allegedly caused by non-public statements made by a stockbroker to a number of clients).

<sup>250</sup> *Worldcom*, 219 F.R.D. at 294.

regardless of procedural timing of the issue's consideration.<sup>251</sup> Moreover, regardless of efficiency generally and depending on the precise facts presented, a court could doubt the impact any particular analyst report had on the subject stock's price.

This is precisely what led Judge Rakoff to deny class certification in the other case: *DeMarco v. Lehman Bros.*<sup>252</sup>

[A] statement of opinion emanating from a research analyst is far more subjective and far less certain, and often appears in tandem with conflicting opinions from other analysts as well as new statements from the issuer. As a result, no automatic impact on the price of a security can be presumed and instead must be proven and measured before the statement can be said to have “defrauded the market” in any material way that is not simply speculative... In some cases, sophisticated statistical techniques may enable a skilled investigator to determine that a given analyst's opinion of a given security has indeed materially impacted market price so as to warrant application of the “fraud-on-the-market” doctrine. But in other cases the claim of measurable impact on the marketplace will be too speculative to support such an application.<sup>253</sup>

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<sup>251</sup> Much has been made of noted securities law Professor John Coffee's opinion that “only in a case where the publication of the [analyst] report clearly moved the market in a measurable fashion would the ‘fraud on the market’ doctrine seem fairly applicable.” John C. Coffee, Jr., *Security Analyst Litigation*, N.Y.L.J., (Sept. 20, 2001), at 5 (premising his conclusion on 1976 and 1999 academic studies showing respectively that analyst's predictions have not been found to be particularly accurate and that the opinions of analysts associated with an issuer's underwriters do not generally move the market for that stock), *quoted in* Hevesi v. Citigroup, Inc., 366 F.3d 70, 79 n.7 (2d Cir. 2004); *DeMarco v. Lehman Bros.*, 03 Civ. 3470 (JSR), 03 Civ. 2705 (JSR), 03 Civ. 4511 (JSR), 2004 U.S. Dist. LEXIS 12438 at \*9 (S.D.N.Y. July 6, 2004).

Similarly, Ferrillo, *et al.* argue that “plaintiffs should be required to earn their rebuttable presumption of reliance by at least making some concrete showing, through a price reaction analysis, that the stock upon which they are suing behaved in an ‘efficient’ manner, by responding rapidly to corporate news and events and performing as finance theory would predict in the absence of such.” 78 ST. JOHN'S L. REV. at 85.

<sup>252</sup> *DeMarco v. Lehman Bros.*, 2004 U.S. Dist. LEXIS 12438.

<sup>253</sup> *Id.* at \*\*7-9.

Judge Rakoff conceded at some length that the “investor is entitled to assume that the analyst is providing his honest opinion, rather than, as here alleged, lying in order to manipulate the market for the benefit of an issuer for which the analyst’s employer is providing lucrative services,” and that some analysts “may have the ability to influence market prices on the basis of their recommendations.”<sup>254</sup> Nonetheless, Judge Rakoff found the proof before him not sufficient to “make a prima facie showing that the analyst’s statements materially impacted the market price in a reasonably quantifiable respect.”<sup>255</sup>

In the end, then, it appears that a key factual question to be answered in each analyst bias case is whether the analyst’s report(s) actually moved the market for the stock that is the subject of the complaint. If it did, market efficiency for that stock generally may become irrelevant, and loss causation also will likely be established.<sup>256</sup> The SEC has taken the position that analysts’ reports do impact market prices and are actually used by investors, including institutional investors, citing a number of financial experts’ compelling academic papers on the subject.<sup>257</sup> Whether it is viewed as a

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<sup>254</sup> *Id.* at \*\*5-6.

<sup>255</sup> *Id.* at \*9. Plaintiffs relied primarily on an expert report prepared by Frank S. Torchio, who also has prepared testimony for the WorldCom case. The court found that Torchio’s report in the DeMarco case stood in “notable contrast” to the report he gave in Worldcom, which “isolated the statements for the particular analyst there involved on days in which there was no confounding information.” In DeMarco, the court found Torchio’s substantially weaker analysis of the Lehman analyst, Stanek’s, effect on the market for RealNetworks’s stock to be “so transparently unreliable as to be inadmissible as a matter of law.” *Id.* at \*14.

<sup>256</sup> See Section VI *infra*.

<sup>257</sup> See, e.g., Paul J. Irvine, *Analysts’ Forecasts and Brokerage Firm Trading*, 79 ACCT. REV. 125 (2004); Alon Brav & Reuven Lehavy, *An Empirical Analysis of Analysts’ Target Prices: Short-term Informativeness and Long-term Dynamics*, 58 J. FIN. 1933 (2003); Cristi A. Gleason and Charles M.C. Lee, *Analyst Forecast Revisions and Market Price Discovery*, 78 ACCT. REV. 193 (2003); Jeffrey A. Busse & T. Clifton Green, *Market Efficiency in Real Time*, 65 J. FIN. ECON. 415 (2002); Brad Barber, et al., *Can Investors Profit from the Prophets? Security Analyst Recommendations and Stock Returns*, 56 J. FIN. 531 (2001); Rick A. Cooper, et al., *Following the Leader: A Study of Individual Analysts’ Earnings Forecasts*, 61 J. FIN. ECON. 383 (2001); Laurie Krigman, et al., *Why do Firms Switch Underwriters?*, 60 J. FIN. ECON. 245 (2001); Kent L. Womack, *Do Brokerage Analysts’ Recommendations Have Investment Value?*, 51 J. FIN. 137 (1996); Scott E. Stickel, *The Anatomy of the Performance of Buy and Sell Recommendations*, FIN.



prerequisite to application of the fraud-on-the-market presumption in a given case, or as the key to proof of loss causation, it appears that the fact an analysts' report(s) moved the market will be instrumental to a finding of liability, whether by a judge at class certification, or ultimately by a jury at trial. The question of loss causation is discussed in more detail in the next Section.

## **Section VI – (Loss) Causation**

Causation is the next, and in this context possibly the most contentious, element of a 10(b) cause of action. Theoretically anyway, causation has two parts: transaction causation and loss causation. Transaction causation, akin to reliance,<sup>258</sup> was discussed in the previous section. The other part, “loss causation,” demonstrates that the fraudulent misrepresentation or omission actually caused the damages or loss suffered.<sup>259</sup> This element is statutory now, having been codified by the Private Securities Litigation Reform Act. In that regard, the PSLRA provides: “in any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.”<sup>260</sup>

This codification of the element did not clarify the loss causation standard to be used by the courts. In fact, since well before the passage of the PSLRA the topic of loss causation has been somewhat unsettled in the Circuits. The Eighth and Ninth Circuits have adopted a relatively loose causation requirement, simply requiring the plaintiffs to

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ANALYSTS J. 24 (Sept/Oct. 1995). More anecdotally, journalists frequently report on stock prices' apparent reactions to analysts' calls. *See, e.g.,* Karen Talley, *Genentech, Cree Fall After Analysts Cut Ratings*, WALL ST. J. (June 12, 2004), at C4;

<sup>258</sup> *See, e.g.,* Suez Equity Investors.

<sup>259</sup> Suez Equity Investors, 250 F.3d at 95-96. (distinguishing between transaction causation, which is more like reliance, and loss causation, which is the causal connection between the fraud and the plaintiffs' losses).

<sup>260</sup> 15 U.S.C. § 78u-4(b)(4).

show “some causal nexus” between their loss and the defendants’ misconduct.<sup>261</sup> The remaining courts apply stricter views of loss causation, with the most rigid – the “direct causation” approach – followed by the Fourth, Fifth, Sixth, and Eleventh Circuits.<sup>262</sup> The Seventh Circuit utilizes a somewhat less restrictive approach, focused on the “materialization of the [undisclosed] risk.”<sup>263</sup>

But the largest number of analyst bias cases will be decided by the Second Circuit Court of Appeals, which has adopted what has been called a “flexible” approach to loss causation, analyzing the element from the perspective of foreseeability.<sup>264</sup> This analysis is more akin to the tort concept of proximate cause, and Second Circuit loss causation cases occasionally even cite the seminal case of *Palsgraf v. L.I.R.R., Co.*,<sup>265</sup> for the proposition that a determination of loss causation is, in the end, one of public policy, requiring conformity with a “rough sense of justice.”<sup>266</sup>

The Second Circuit’s seminal 10(b) loss causation case for our consideration was one involving fraud in connection with stock recommendations by a non-analyst. The

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<sup>261</sup> See, e.g., *Gebhart v. ConAgra Foods, Inc.*, 335 F.3d 824 (8<sup>th</sup> Cir. 2003); *In re Control Data Corp. Sec. Litig.*, 933 F.2d 616 (8<sup>th</sup> Cir. 1991); *Broudo v. Dura Pharm., Inc.*, 339 F.3d 933 (9<sup>th</sup> Cir. 2003); *Provenz v. Miller*, 102 F.3d 1478 (9<sup>th</sup> Cir. 1996). On June 29, 2004, the U.S. Supreme Court agreed to hear an appeal of the Broudo decision. Mark H. Anderson, *High Court to Review Standard Required to Sue over Stock Losses*, WALL ST. J., June 29, 2004, at A6.

<sup>262</sup> See generally David S. Escoffery, Note, *A Winning Approach to Loss Causation Under Rule 10b-5 in Light of the Private Securities Litigation Reform Act of 1995 (“PSLRA”)*, 68 FORDHAM L. REV. 1781 (April 2000).

<sup>263</sup> See, e.g., *Bastian v. Petren Resources Corp.*, 892 F.2d 680 (7<sup>th</sup> Cir. 1990). It is worth mentioning that a panel of the Second Circuit apparently prefers the Seventh Circuit’s approach to loss causation, writing in a footnote that were it “unconstrained by [its] own precedents, [it] might propose a different standard” noting that the materialization of the risk approach utilized in *Bastian* appears to be “both principled and predictable.” *Suez Equity Investors*, 250 F.3d at 98, n.1.

<sup>264</sup> “[L]oss causation . . . examines how directly . . . [the fraudulent conduct] caused the loss, and whether the resulting loss was a foreseeable outcome of the fraudulent [conduct].” *Suez Equity Investors*, 250 F.3d at 96 (summarizing the Court of Appeals for the Second Circuit’s definition of loss causation); see also *Citibank, N.A. v. K-H Corp.*, 968 F.2d 1489, 1495 (2d Cir. 1992) (stating that the securities fraud element of loss causation requires plaintiffs to prove “that the damage suffered was a foreseeable consequence of the misrepresentation.”).

<sup>265</sup> 162 N.E. 99 (1928).

<sup>266</sup> *Id.* at 103 (Andrews, J., dissenting). See *Suez Equity Investors v. Toronto Dominion Bank*, 250 F.3d 87, 96 (2d Cir. 2001); *AUSA Life Ins. Co. v. Ernst and Young*, 206 F.3d 202, 210 (2d Cir. 2000).

case of *Marbury Management, Inc. v. Kohn*<sup>267</sup> well illustrates the foreseeability test for loss causation. Kohn, a trainee employed by a broker-dealer, misrepresented himself as a “lawfully licensed registered representative,”<sup>268</sup> recommended, and sold securities to the plaintiff.<sup>269</sup> Plaintiff purchaser alleged that it became concerned about the performance of the stock, but was persuaded by the trainee to continue to hold the stocks, until such time as the fraud was revealed and the stocks were sold at a loss.<sup>270</sup> The trial court found that Kohn’s misrepresentation induced not only the sale but also the plaintiff’s subsequent retention of the securities, which affected the extent of the loss.<sup>271</sup> Even though Kohn’s fraud was not the cause of the decline in the stock’s price, the court found loss causation to have been established because the plaintiff’s injury was a reasonably foreseeable consequence of the fraud.<sup>272</sup>

In the more typical investor class action involving a drop in stock prices, the plaintiff surmounts the loss causation hurdle at the pleading stage by tying a material price decline in the security to a “corrective disclosure” or subsequent public statement by the issuer correcting a prior alleged misstatement or omission.<sup>273</sup> The *Marbury* court expressly recognized that its facts did not follow the traditional pattern for assessment of the cause of injury in securities fraud cases. However it felt strongly that “plaintiffs in a

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<sup>267</sup> 629 F.2d 705 (2d Cir. 1980).

<sup>268</sup> Kohn also represented himself to plaintiffs as a “broker,” a “portfolio management specialist,” and a “security analyst.” *Id.* at 707.

<sup>269</sup> *Id.*

<sup>270</sup> *Id.*

<sup>271</sup> *Id.* at 708.

<sup>272</sup> *Id.* at 709. (affirming trial court’s judgment against Kohn).

<sup>273</sup> The Third Circuit Court of Appeals has described “the usual securities action” as follows:

plaintiffs complain because some announcement emanating from the company, whether regarding a tender offer, ... earnings, ... projected earnings, ... or the company's financial condition, ... fraudulently represented the actual state of affairs. Plaintiffs claim that, as a result, they purchased the securities at a price that was artificially inflated, only to suffer a loss when the true situation was made known.”

*E.P. Medsystems v. Echocath*, 235 F.3d 865, 884 (3d Cir. 2000) (internal citations omitted).

case such as this, whether or not their claims fall under the more familiar rubric, are, nevertheless, entitled to recover the damages that they suffered as a proximate result of the allegedly misleading statements.”<sup>274</sup> Thus given the somewhat unique fact pattern – involving the fraud’s inducement of both the sale and subsequent retention of the securities, during which period they lost value – the court could permit both transaction causation and loss causation to be established with the same basic allegations,<sup>275</sup> noting that

differentiating transaction causation from loss causation can be a helpful analytical procedure only so long as it does not become a new rule effectively limiting recovery for fraudulently induced securities transactions to instances of fraudulent representations about the value characteristics of the securities dealt in. So concise a theory of liability for fraud would be too accommodative of many common types of fraud, such as the misrepresentation of a collateral fact that induces a transaction.<sup>276</sup>

Bolstering its ruling, the court analogized to three cases pre-dating the ’33 and ’34 Acts, noting that liability for representations having the same effect as Kohn’s was “familiar in the law even before the [federal securities statutes] were enacted.”<sup>277</sup>

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<sup>274</sup> *Id.* at 708, (citing *Globus Research Service, Inc.*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970))

<sup>275</sup> *Id.* at 710. *See also* *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974) (reversing dismissal and finding both loss causation and transaction causation to have been adequately alleged by statement that defendant’s misrepresentations manipulated the price at which plaintiff was forced to exchange his shares as a result of a merger, and he sustained injury thereby.)

<sup>276</sup> *Id.* at 710 n.3.

<sup>277</sup> *Id.* at 709, analogizing to *Rothmiller v. Stein*, 38 N.E. 718 (N.Y. App. 1894); *David v. Belmont*, 197 N.E. 83 (Mass. 1935); *Cartwright v. Hughes*, 147 So. 399 (1933); *Continental Ins. Co. v. Mercadante*, 225 N.Y.S. 488 (N.Y. App. 1927). On that same point, the court quoted *Hotaling v. A.B. Leach & Co.*, 159 N.E. 870 (N.Y. App. 1928), as follows: “As long as the fraud continued to operate and to induce the continued holding of the bond, all loss flowing naturally from that fraud may be regarded as its proximate result.”

In fact, as it turns out, Second Circuit loss causation precedents tend not to have arisen in cases conforming to the more familiar rubric. Instead the facts presented by many of the court's pronouncements on the subject have involved face-to-face misrepresentations, usually impacting the risk undertaken by the investing company. Naturally, the results have been highly fact dependant. In a number of the more recent opinions the court has found loss causation allegations to have been adequately pled and/or proven based on the foreseeability of the alleged harm.<sup>278</sup> The opposite is also true, particularly where an intervening cause can be established.<sup>279</sup>

Also serving as background to the analysis at hand are a number of specific foreseeability formulations that have surfaced in the Second Circuit in the 10(b) context. For example writing for the Court, Judge Oakes in *AUSA Life Ins. Co. v. Ernst & Young*<sup>280</sup> held that the appropriate test for loss causation is whether “there was a reasonable probability that the fraud actually accomplished the result it was intended to bring about.”<sup>281</sup> Judge Oakes remanded the suit to the trial court, with Judge Jacobs

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<sup>278</sup> Castellano, 257 F.3d at 190 (finding summary judgment to have been improperly granted based on failure to adequately allege loss causation); *Suez Equity Investors, L.P. v. Toronto Dominion Bank*, 250 F.3d 87 (2d Cir. 2001) (; *AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202 (2d Cir. 2000) (vacating district court's finding that loss causation had not been adequately proven and remanding for further fact finding as to foreseeability); *Mfrs. Hanover Trust Co. v. Drysdale Sec. Corp.*, 801 F.2d 13 (2d Cir. 1986) (approving of jury instruction that loss causation was proven where “the damage was either a direct result of the misleading statement or one which could reasonably have been foreseen,” in case involving misrepresentation of “investment quality” of repurchase transactions in government securities).

<sup>279</sup> The court itself describes some of these cases as follows, distinguishing them from its analysis in *Castellano v. Young & Rubicam, Inc.*:

See *Powers*, 57 F.3d at 189 (market value of stock fell as a result of recession); *Gelt Funding*, 27 F.3d at 772 (investor's loss caused by marketwide real estate crash); *Citibank, N.A. v. K-H Corp.*, 968 F.2d 1489, 1495 (2d Cir. 1992) (loss to plaintiff from loans made on the basis of fraudulent misrepresentation were the result of a decline in value of collateral unrelated to the fraud); *Bloor v. Carro, Spanbock, Londin, Rodman & Fass*, 754 F.2d 57, 62 (2d Cir. 1985) (loss caused not by misrepresentations in various documents used to attract investments but by looting and mismanagement of these funds by controlling stockholders).  
257 F.3d 171, 189-190 (2d Cir. 2001). Regarding the intervening cause defense, *see also* RESTATEMENT (SECOND) OF TORTS § 548A at 107 (1977).

<sup>280</sup> 206 F.3d 202 (2d Cir. 2000).

<sup>281</sup> *Id.* at 212, *quoting* *Continental Ins. Co. v. Mercadante*, 225 N.Y.S. 488, 494 (N.Y. App. 1927).

concurring in that result but not with the loss causation analysis; then-chief Judge Winters dissented as to the remand, feeling more strongly than Judge Oakes that loss causation had already been proven as a matter of law.<sup>282</sup> A panel of the Second Circuit discussing *AUSA*'s procedurally fractured opinions in a later case found that Judge Winter's views gave "valuable content" to Judge Oakes's reasonable probability test.<sup>283</sup> In his opinion, Judge Winter had urged that loss causation requires:

... consideration of the significance to a reasonable investor of the truth compared to the content of the misrepresentations or omissions. If the significance of the truth is such as to cause a reasonable investor to consider seriously a zone of risk that would be perceived as remote or highly unlikely by one believing the fraud, and the loss ultimately suffered is within that zone, then a misrepresentation or omission as to that information may be deemed a foreseeable or proximate cause of the loss.<sup>284</sup>

Certainly under the basic foreseeability analysis required in the Second Circuit, a plausible inference can be drawn in the analyst bias cases that either (1) the fraud accomplished its purpose, in that investors continued to buy the stock notwithstanding the underlying valuation of the investment quality was not there, a fact analysts knew but that was not discovered until later, or (2) the analysts themselves were in the best position to foresee the collapse of the market for the investments they were touting, given their status as professionals and specialists in the given industry, with far more of a bird's eye view of the sector as a whole over time as well as superior more detailed intelligence as to the meaning of various events and occurrences therein and with regard to individual issuers,

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<sup>282</sup> *Id.* at 224-228 (Jacobs, J., concurring) and 228-239 (Winter, C.J., dissenting).

<sup>283</sup> *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 188 (2d Cir. 2001).

<sup>284</sup> 206 F.3d at 235.

or (3) at the very least that the market collapse following discovery of systematic overvaluation – including the massive loss in value of the stocks in which plaintiffs invested – was within the “zone of risk” that investor plaintiffs would not have appreciated, but analysts did.<sup>285</sup>

Despite ample and recent authority sanctioning it, this simple foreseeability rationale may not win the day in the analyst bias cases. More currently, in its 2001 decision in *Suez Equity Investors v. Toronto Dominion Bank*,<sup>286</sup> the Court expressly attempted to reconcile the Circuit’s different strands of reasoning on loss causation.<sup>287</sup> There, the defendants had pitched an investment in a healthcare financing venture called SAM Group by redacting certain negative information – about SAM Group’s principal, Mallick, and past business and financial difficulties he had had – from a due diligence background report on Mallick requested by the plaintiffs. Soon after plaintiffs invested, SAM Group collapsed in a liquidity crisis. In their complaint, they alleged that it was Mallick’s mismanagement that caused SAM’s demise. The court found that loss causation had been adequately pleaded, reversing the district court’s dismissal, because the omitted negative information could have made foreseeable Mallick’s failure

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<sup>285</sup> No doubt a number of defendants in the analyst bias cases will argue that an intervening event – the so-called “bursting of the bubble” or overall collapse of the Internet/technology/communications investment sector – was the proximate cause of plaintiffs’ losses, and so loss causation was not properly pled or cannot be established as a matter of law. See notes \* - \* and accompanying text. The Second Circuit was persuaded of this in a RICO case, *First Nationwide Bank v. Gelt Funding Corp.* 27 F.3d 763, 769-70 (2d Cir. 1994). The Court of Appeals there approved the use of a three-part test for determining proximate cause where a borrower is alleged to have misrepresented the value of collateral or its income, in connection with a non-recourse real estate purchase money loan. These are (1) the magnitude of the misrepresentation in value of the property, (2) the time elapsing between the misrepresentation and the loss, and (3) the effect of external factors. In that case, where the magnitude of misrepresentation was unclear, the losses occurred five years after the purported misrepresentations, and a general real estate market decline had occurred in the relevant area, loss causation was not adequately pleaded. The court, however, went out of its way to say “We do not mean to suggest that in all cases a fraud plaintiff will be unable to plead proximate cause when the claim follows a market collapse. In this case, it is the cumulative effect of the considerations discussed above, rather than any single factor, that compels our decision.” *Id.* at 772.

<sup>286</sup> 250 F.3d at 87.

<sup>287</sup> *Id.* at 98, n.1.

effectively to manage SAM. Relying heavily on the distinction between *Marbury Management*, and *Bennett v. U.S. Trust Co.*,<sup>288</sup> the rule as stated in *Suez Equity* was “plaintiffs may allege transaction and loss causation by averring both that they would not have entered the transaction but for the misrepresentations and that the defendants’ misrepresentations induced a disparity between the transaction price and the true ‘investment quality’ of the securities at the time of transaction.”<sup>289</sup>

The Second Circuit’s most recent loss causation opinion is *Emergent Investment Capital Management, LLP v. Stonepath Group, Inc.*,<sup>290</sup> which purports to clarify the *Suez Equity* rule. The suit arose out of defendants’ failure to disclose a relationship between the issuer and one Howard Appel, who was alleged to be the mastermind behind numerous similar “pump and dump” schemes.<sup>291</sup> In addition to this omission, plaintiffs also alleged that defendants artificially inflated the stock’s price, that defendants were in a position to “manipulate [relevant] stock prices,” and that they had made “substantial” sales of the relevant stock during the relevant period.<sup>292</sup> The court found that under a liberal reading of the complaint, the stock the plaintiffs purchased could be viewed as one

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<sup>288</sup> 770 F.2d 308 (2d Cir. 1985). The Bennetts allegedly were told that federal margin rules did not apply to public utility stock deposited with a bank as collateral, enabling them to purchase more than \$1 million dollars worth of such stocks on margin in an “undermargined” account. Eventually the dividends paid by the stocks were insufficient to cover the interest expense on the loans and when the investments also declined in value, the bank sold the stocks and the resulting deficiency was nonetheless more than \$1 million. The *Suez Equity* court said the following about *Marbury* and *Bennett*:

Because the misrepresentation in *Marbury Management* induced the purchase (transaction loss) and related to the stock’s value (loss causation), it was causally related to the loss. In *Bennett* since the margin rules [the subject of defendant’s alleged misrepresentation] were extrinsic to the stock, the complaint failed to allege loss causation.

*Id.* at 97.

<sup>289</sup> *Id.* at 97-98.

<sup>290</sup> 343 F.3d 189 (2d Cir. 2003).

<sup>291</sup> The court describes a pump and dump scheme one “where the company principals artificially inflated [the] stock prices before ‘dumping’ their own shares ... on the market,” *Id.* at 197, citing 3 THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 14.18 (4th ed. 2002).

<sup>292</sup> *Id.* at 197-98.



of the defendants' pump and dump schemes, and that loss causation was adequately pleaded by virtue of the pump and dump allegations.<sup>293</sup>

After so holding the court explained in a separate section of the opinion that it had not in *Suez Equity* intended to establish a rule that allegations of artificial price inflation caused by the defendants standing alone were enough to satisfactorily plead loss causation.<sup>294</sup> Instead, the court explained in *Emergent Capital*, a "second, related loss" in addition to the "purchase-time value disparity" had actually been alleged in *Suez Equity*.<sup>295</sup> According to the court, that second related loss was Mallick's "concealed lack of managerial ability induced [the company's] failure."<sup>296</sup> Though not expressed as such, apparently the second, related loss in *Emergent Capital* was the defendants' manipulation of the stock prices and subsequent substantial sales of the artificially inflated stock.

Not reconciled in the *Emergent Capital* case is the Circuit's well entrenched holding in *Marbury Management*.<sup>297</sup> Arguably, a second, related loss alleged in *Marbury Management* was the fact that the plaintiff was convinced by the trainee (based on his continuing fraudulent representations as to his qualifications as a stock analyst and investment specialist) to hold the recommended stocks beyond when it had misgivings about them. The *Suez Equity* court had identified the causal link in *Marbury* as the fact the trainee's advice and recommendations were related to the stock's "investment

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<sup>293</sup> 343 F.3d at 198.

<sup>294</sup> *Id.* Plaintiffs had alleged an independent basis for establishing loss causation, namely that defendants' omissions "induced a disparity between the price plaintiff paid for the ...shares and their true investment quality." *Id.*, citing plaintiffs Second Amended Complaint at paragraph 79(ii).

<sup>295</sup> 343 F.3d at 198.

<sup>296</sup> *Id.*

<sup>297</sup> The vitality of that holding did not appear to be in doubt up to the point *Emergent Capital* was decided. *Suez Equity* relied in great part on it, as had other Second Circuit opinions preceding it. *See, e.g.*, *Castellano*, 257 F.3d at 187; *AUSA*, 206 F.3d at 211; *Mfrs. Hanover Trust*, 801 F.2d at 21-22. Moreover, as recently as 2002, in an unpublished opinion following the remand of the *AUSA* case, *supra*, a different panel of the Second Circuit expressly reaffirmed *Marbury*'s rationale, while recognizing that its holding was inapplicable to the case there at hand. *AUSA Life Ins. Co. v. Ernst & Young*, 39 Fed. Appx. 667, 673 (2d Cir. 2002).

quality.”<sup>298</sup> Reading *Suez Equity* and *Emergent Capital* together, it appears that an initial fraud inducing the plaintiff’s purchase at an artificially high price must be coupled with a second related loss, which can be an inducement to continue to hold the stock by a continuing misrepresentation or omission that relates to the investment quality of the stock.

Confounding the opacity of the Second Circuit’s loss causation jurisprudence, is *Rothman v Gregor*,<sup>299</sup> a case that was pending and argued quite contemporaneously with *Suez Equity* but by a different panel of the Second Circuit, and which is still good law.<sup>300</sup> That 10(b) case involved misrepresentations by the issuer with regard to its capitalization, versus expensing, of royalty advances. The complaint alleged that the losses plaintiffs sustained during the class period were attributable not to the misrepresented accounting policy itself, but due to the market’s reaction to knowledge of an imminent massive write down required by adjustment of the faulty accounting practice.<sup>301</sup> According to the court, these allegations did permit the required loss causation showing to be made, with the question for the jury to be whether the issuer “could reasonably foresee that its fraudulent failure to expense would lead to a drop in GT’s stock price whenever the market became aware of the impending writedown” because its reported earnings during the class period

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<sup>298</sup> *Suez Equity*, 250 F.3d at 97.

<sup>299</sup> 220 F.3d 81, 95-96 (2d Cir. 2000).

<sup>300</sup> *Rothman* was argued in June 2000 and decided in July 2000 by a panel consisting of Justices Oakes, Newman & Straub. *Suez Equity* was argued in May 2000, and ultimately decided in May 2001 by a panel consisting of Chief Justice Cardamone, and Justices Miner, and Walker. While the *Suez Equity* opinion, authored by Justice Cardamone (as was *Emergent Capital* a year later) purports to attempt to harmonize loss causation precedent within the circuit, it makes no reference whatever to the *Rothman* opinion, which is completely consistent with Judge Oakes’s previous opinions in *AUSA* and .

<sup>301</sup> Coincidentally, and with no indication that there was any analyst bias involved (perhaps to the contrary), plaintiffs contended that the market reaction was precipitated in part by a research analyst’s reporting on the possible write-off and downgrading of the stock. *Id.* at 87, 95.

may well have been losses.<sup>302</sup> A straight foreseeability analysis, then appears to still be preferred at least by some members of the Second Circuit. Perhaps more importantly, the *Rothman* fact pattern is somewhat analogous to the analyst bias fact pattern, in the sense that the bubble burst at or near the time the market became generally aware of analysts' conflicts and general lack of candor with regard to so many Internet and other "hot" sector stocks.

Reading the *Rothman*, *Suez Equity*, and *Emergent Capital* opinions consistently would appear to permit the required finding of loss causation in analyst bias cases at least at the pleading stage. It is certainly arguable that analysts not only knew they were pumping up the bubble as they pumped up stock prices, but it was then also foreseeable to analysts that when their secret opinions and/or the systemic bias was discovered, the market's reaction would have a negative impact on prices, correcting stocks to nearer their true values and causing losses to those who bought at artificially high prices and held the stocks through their decline. While one district court judge has steadfastly refused to find loss causation to be present in analyst bias cases before him, the majority considering this issue in analyst bias cases to date has agreed with this result. The following subsection details a number of the illustrative rulings on this issue so far.

#### **(b) Pending Analyst Bias Cases**

The cases decided thus far in the district courts have come down both ways on loss causation, weighted by number in favor of permitting the issue of loss causation to proceed to a jury. For example, in *DeMarco v. Robertson Stephens*,<sup>303</sup> Judge Lynch of the Southern District of New York ruled that loss causation had been adequately pleaded,

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<sup>302</sup> *Id.* at 95-96.

<sup>303</sup> No. 03 Civ. 590 (GEL), 2004 U.S. Dist. LEXIS 265 (S.D.N.Y. Jan. 9, 2004).

taking the practical view that it was for the jury to assess the plaintiffs' theory of the case, which is that the analysts' misrepresentations inflated the bubble, which then foreseeably burst.<sup>304</sup> According to Judge Lynch, the artificial price inflation created by the defendants' misrepresented opinions, which is itself not sufficient to adequately allege loss causation under *Emergent Capital*, certainly contained the "seeds" of loss causation, given the inevitability of a market correction.<sup>305</sup>

Similarly, in *DeMarco v. Lehman Bros.*,<sup>306</sup> Judge Rakoff of the Southern District took the position that loss causation was adequately pleaded by virtue of allegations that the plaintiffs' losses resulted from the "marketplace's reaction to the revelation of the truth that defendant's actionable statements concealed (as contrasted to independent market forces)."<sup>307</sup> The issue as framed in that case is more like the "familiar rubric" securities fraud cases, in which a corrective statement apprised the market of the concealed information that had led the analyst to harbor his secretly negative view. These allegations, according to Judge Rakoff, suffice for loss causation "under any standard."<sup>308</sup>

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<sup>304</sup> *Id.* at \*32-33.

<sup>305</sup> *Id.* at \*32.

<sup>306</sup> 309 F.Supp.2d 631 (S.D.N.Y. 2004).

<sup>307</sup> *Id.* at 636. The evidence was to the contrary in *Robbins v. Koger*, 116 F.3d 1441, 1448-1449 (11<sup>th</sup> Cir. 1997) (reversing jury's finding of loss causation).

<sup>308</sup> *Id.* Judge Denise Cote of the Southern District has also held on a motion to dismiss that loss causation was adequately pleaded against the analyst and broker-dealer in *In re Worldcom, Inc. Sec. Litig.*, 294 F.Supp. 2d 392, 428-429 (S.D.N.Y. 2003). She reasoned that "given Grubman's historical role in creating demand for WorldCom securities, when the alleged illicit relationship came to light, the disclosure contributed to the decline in price of WorldCom's securities." *Id.* at 429. Judge Cote also found in the case before her a "striking resemblance" to *Marbury Management*: "plaintiffs have alleged that the material omissions concerned the integrity and reliability of the premier analyst for the telecommunications industry. As was true in *Marbury Management*, these alleged omissions are sufficiently related to the value of the stock recommended by Grubman to satisfy the requirements for pleading loss causation." *Id.*

The trial court also has ruled favorably to plaintiffs on this issue in a case captioned *Fogarazzo v. Lehman Bros.*<sup>309</sup> There Judge Scheindlin read *Emergent Capital* somewhat more literally as requiring “something more” than artificial price inflation caused by the defendants’ misrepresentations.<sup>310</sup> According to Judge Scheindlin, the “something more” in both the *Suez Equity* and *Emergent Capital* cases was that the “ultimate decline in the companies’ stock price was attributable to the very thing that the defendants allegedly lied about.”<sup>311</sup> By analogy, in the case before her, the securities issuer “ultimately failed because of the very facts that the [defendants] misrepresented: that [the relevant stock issuer] was in financial trouble and that the entire ‘internet telephony sector’ was collapsing.”<sup>312</sup> She also analogized the analysts’ disingenuous opinions to the redacted background report in *Suez Equity*: the analysts obscured the true facts about the investment quality of the stock by injecting their “purportedly expert” opinions into the marketplace to obscure the logical conclusion to be drawn from objective facts about the issuer, i.e. that it was failing.<sup>313</sup> Thus, she concludes that loss causation was adequately pleaded:

In sum, the [defendants], knowing that [the issuer] was actually in decline, inflated the price of [its] shares and then worked doubly hard to conceal or obfuscate the

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<sup>309</sup> 03 Civ. 5194 (SAS), 2004 U.S. Dist. LEXIS 9193 (S.D.N.Y. May 21, 2004). *See also* Judge Scheindlin’s loss causation opinion denying defendants’ motion for judgment on the pleadings in an analogous market manipulation suit against numerous underwriter/broker dealers, *In re IPO Sec. Litig.*, 297 F. Supp. 2d 668 (S.D.N.Y. 2003).

<sup>310</sup> *Fogarazzo*, 2004 U.S. Dist. LEXIS 9193 at \*33. Judge Scheindlin concludes that the “something more” that must be pleaded need not constitute an independent cause of the plaintiffs’ losses. *Id.*

<sup>311</sup> *Id.* at \*39.

<sup>312</sup> *Id.* at \*41.

<sup>313</sup> *Id.* at \*42-43.

meaning of every fact that would have revealed that decline to the investing public. How could the [defendants] *not* have foreseen the loss to investors?<sup>314</sup>

On the other hand, Sr. District Judge Pollack has rejected plaintiffs' attempts to plead loss causation in the consolidated class action suits against Merrill Lynch. Specifically, in several related opinions, Judge Pollack has views the analyst bias cases as essentially involving investors' assumption of the risk.<sup>315</sup> In his view, the plaintiffs in the cases before him have either failed to plead more than simple artificial price inflation,<sup>316</sup> which *Emergent Capital* teaches is not enough, and/or that the bursting of the stock market bubble is an intervening event that breaks any chain of proximate cause that would exist.<sup>317</sup> He makes much of the fact that the analyst bias cases involve not face-to-face misrepresentations, but instead depend on the fraud-on-the-market presumption to

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<sup>314</sup> *Id.* at \*49-50.

<sup>315</sup> Judge Pollack's apparent predisposition is to hold individual investors accountable for their own losses arising out of the recent bubble market. For example, in the 24/7 Real Media decision, he describes the plaintiffs as

among the high risk speculators who, knowing full well or being properly chargeable with appreciation of the unjustifiable risks they were undertaking in the extremely volatile and highly untested stocks at issue, now hope to twist the federal securities laws into a scheme of cost-free speculators' insurance.

In re Merrill Lynch & Co., Research Reports Sec. Litig., 273 F. Supp. 2d at 358. He further elaborates: Seeking to lay the blame for the enormous Internet Bubble solely at the feet of a single actor, ..., plaintiffs would have this Court conclude that the federal securities laws were meant to underwrite, subsidize, and encourage their rash speculation in joining a freewheeling casino that lured thousands of obsessed with the fantasy of Olympian riches, but which delivered such riches to only a scant handful of lucky winners. ... Had the plaintiffs themselves won the game instead of losing, they would have owed not a single penny of their winnings to those they left to hold the bag (or to defendants).

*Id.* And in yet another place, he says "...plaintiffs brought their own losses upon themselves when they knowingly spun an extremely high-risk, high-stakes wheel of fortune." *Id.* More succinctly in an earlier group of cases, Judge Pollack had described other 10(b) plaintiffs simply as "gamblers in the world's gaming pits," summarily dismissing their six related suits *sua sponte*. See, e.g., Thomson v. Morgan Stanley Dean Witter, Inc., No. 01 CIV 7071 (MP), 2001 U.S. Dist. LEXIS 12667 (S.D.N.Y. August 21, 2001).

<sup>316</sup> See, e.g., Merrill Lynch, 273 F. Supp.2d 351, 364 (S.D.N.Y. 2003) (dismissing 24/7 Real Media and Interliant complaints); In re Merrill Lynch Tyco Research Reports Sec. Litig., No. 03 CV 4080 (MP), 2004 U.S. Dist. LEXIS 2247, \*4-10 (S.D.N.Y. February 18, 2004) (dismissing Tyco complaint).

<sup>317</sup> See, e.g., Merrill Lynch, 273 F. Supp. 2d at 364-365; In re Merrill Lynch & Co., Inc. Research Reports Sec. Litig., 289 F. Supp. 2d 416, 421-422 (S.D.N.Y. 2003) (dismissing eToys, Homestore.com, iVillage, Lifeminders, LookSmart, Openwave Systems, Pets.com, and Quokka Sports complaints).

establish transaction causation. Thus, he distinguishes seemingly analogous Second Circuit case law, i.e. *Marbury Management*, in favor of heavy reliance on the Second Circuit’s primary “intervening cause” opinion, *First Nationwide Bank v Gelt Funding Corp.*,<sup>318</sup> and those of other circuits.<sup>319</sup>

The Second Circuit has yet to weigh in on the subject of loss causation in a case involving the analyst bias fact pattern. The only Circuit Court of Appeals to address the issue in this context is the Eleventh,<sup>320</sup> in *LaGrasta v. First Union National Bank*.<sup>321</sup> In *LaGrasta*, failure to adequately plead loss causation was argued by defendants but was not addressed by the trial court, as it disposed of the case on statute of limitations grounds. On appeal, the Eleventh Circuit reversed the statute of limitations ruling and remanded for consideration of defendant’s loss causation arguments. In *dicta* the opinion suggested the district court consider the effect the Private Securities Litigation Reform Act generally may have had on the Circuit’s loss causation precedent, and also whether that statute’s codification of the element altered the traditional notice pleading standards.<sup>322</sup> This limited discussion does not appear to provide any further guidance on the topic.

## Section VII – Damages

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<sup>318</sup> 27 F.3d 763 (2d Cir. 1994). The intervening cause alleged in *Gelt* was the collapse of the real estate market *five years* after defendants made misrepresentations, *inter alia*, about the quality of their rent rolls. The *Gelt* court found that the intervening general decline in market prices substantially caused the collateral’s reduction in value, and hence plaintiff’s losses. *Id.* at 772.

<sup>319</sup> See, e.g., *Merrill Lynch*, 289 F. Supp.2d at 422, *citing* *Bastian v. Petren Resources Corp.*, 892 F.2d 680 (7<sup>th</sup> Cir. 1990) and *Brandenburg v. Seidel*, 859 F.2d 1179 (4<sup>th</sup> Cir 1988).

<sup>320</sup> Interestingly, it has been noted that the Eleventh Circuit is one of the most defense-friendly circuits in the nation when it comes to dismissal of securities fraud cases. Steve Ellman, *Fixed Fight?* MIAMI DAILY BUS. REV. (May 14, 2004).

<sup>321</sup> 358 F.3d 840 (11<sup>th</sup> Cir. 2004).

<sup>322</sup> *Id.* at 851 (*citing inter alia* *Gebhardt v. Conagra Foods, Inc.*, 335 F.3d 824, 830 n.3 (8<sup>th</sup> Cir. 2003), not an analyst case, for the proposition that it does not).

Of course, there is a distinction between the loss causation requirement and proof of damages. To satisfy the element of loss causation, a plaintiff need not show that a misrepresentation or omission was the sole cause of the investment's decline in value. Ultimately, however, the plaintiff will be allowed to recover only those damages actually caused by the misrepresentation. Neither section 10(b) nor Rule 10b-5 specifies an appropriate measure of damages. Thus at least one observer has noted that "the question of damages under Rule 10b-5 is extremely open-ended."<sup>323</sup> A more cynical court concluded that it is a "confused area of the law where the courts, forced to rely on their own wits, have created a myriad of approaches."<sup>324</sup>

Damages in a 10(b) case are delimited by Sections 28(a) of the Exchange Act,<sup>325</sup> and 21D(e) of the Private Securities Litigation Reform Act.<sup>326</sup> The latter is discussed further on in this section; the former provides, in pertinent part: "No person permitted to maintain a suit for damages under the provisions of this title shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of."

Given the broad nature of this statutory prescription, and in light of the two Supreme Court cases ruling on damages in securities fraud cases, the rule for damages under 10(b) is quite flexible and inclusive. In *Affiliated Ute*, the Court ruled that the

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<sup>323</sup> J. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 810 (1991); *see also* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 1060 (3d ed. 1995) ("Section 10(b) and Rule 10b-5 specify no damage or rescission standards, prompting the courts to take an ad hoc approach that often uses the common law out-of-pocket measure as an initial reference point and allows appellate courts to exercise the discretion traditionally left to the trial courts in finding damages appropriate to the facts of the case.") (citation and internal quotations omitted).

<sup>324</sup> Lewis D. Lowenfels and Alan R. Bromberg, *Compensatory Damages in Rule 10b-5 Actions: Pragmatic Justice or Chaos?*, 20 SETON HALL L. REV. 1083, 1084 and 1113 (2000), *quoting* Koch v. Koch Indus., Inc., 6 F. Supp.2d 1192, 1201 (D. Kan 1998).

<sup>325</sup> 15 U.S.C. §78bb(a). The U.S. Supreme Court has assumed that Section 28(a) applies to 10(b) cases. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972).

<sup>326</sup> 15 U.S.C. §78u-4(e).



measure of a defrauded seller's damages could include both out-of-pocket damages and "windfall" or disgorgement damages, applicable for example where the purchaser resells the plaintiff's shares at a profit:

In our view, the correct measure of damages under §28 of the [Exchange] Act, ..., is the difference between the fair value of all that the ... seller received and the fair value of what he would have received had there been no fraudulent conduct, ... except for the situation where the defendant received more than the seller's actual loss. In the latter case, the damages are the amount of the defendant's profit.<sup>327</sup>

Subsequently, in *Randall v. B.J. Loftsgaarden*<sup>328</sup> the Court permitted a rescissory measure of damages for a defrauded buyer, not limited to the "net economic harm" suffered.<sup>329</sup> Lower courts have found out-of-pocket, windfall, rescissory, benefit-of-the-bargain, and disgorgement/unjust enrichment/constructive trust, consequential damages, and yet other measures appropriate in various 10(b) scenarios.<sup>330</sup>

Nonetheless, the measure of damages in a typical 10b case is out-of-pocket losses,<sup>331</sup> or the difference between the price paid and the value actually received. The

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<sup>327</sup> *Affiliated Ute*, 406 U.S. at 155, *citing* *Myzel v. Fields*, 386 F.2d 718, 748 (8<sup>th</sup> Cir. 1967) and *Janigan v. Taylor*, 344 F.2d 781, 786 (1<sup>st</sup> Cir. 1965).

<sup>328</sup> 478 U.S. 647 (1986).

<sup>329</sup> *Id.* at 663.

<sup>330</sup> *See, e.g.*, Lowenfels and Bromberg, *supra* note n- . For a more thorough discussion of damages in securities fraud cases, *see generally* Andrew L. Merritt, *A Consistent Model of Loss Causation in Securities Fraud Litigation: Suing the Remedy to the Wrong*, 66 TEX. L. REV. 469 (1988); Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611 (1985); Robert B. Thompson, *The Measure of Recovery under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349 (1984).

<sup>331</sup> *Randall*, 478 U.S. at 661-62; *id.* at 668 (Blackmun, J., concurring) ("Normally . . . the proper measure of damages in a §10(b) case is an investor's out-of-pocket loss . . ."); *see also* *Lawton v. Nyman*, 327 F.3d 30, 42-43 (1<sup>st</sup> Cir. 2003); *Mathews v. Kidder, Peabody & Co.*, 260 F.3d 239, 250 (3<sup>rd</sup> Cir. 2001); *DCD Programs Ltd. v. Leighton*, 90 F.3d 1442, 1446-1447 (9<sup>th</sup> Cir. 1995); *Stone v. Kirk*, 8 F.3d 1079, 1092 (6<sup>th</sup> Cir. 1993); *Feldman v. Pioneer Petroleum, Inc.*, 813 F.2d 296, 301 (10<sup>th</sup> Cir. 1987); *Huddleston v. Herman & McLean*, 640 F.2d 534, 556 (5<sup>th</sup> Cir. 1981).

difficulty is in proving the value of what was received, and in removing from plaintiffs' recovery other losses associated with general market effects unrelated to the fraud.<sup>332</sup>

The precise calculations in a given case are typically the province of expert testimony.<sup>333</sup>

How a given plaintiff fares will also depend on how the burden of proof is allocated on this issue.<sup>334</sup>

Many courts have been inclined to permit the stock's value after a corrective disclosure to stand in for its value as of the date of the initial transaction. The measure of plaintiffs' damages then can be called the "expedient" out of pocket measure, avoiding the vagaries of proof of what the stock was theoretically worth on the date of the plaintiff's transaction.<sup>335</sup> This shifts to defendants the burden of paying for any non-fraud driven changes in market value.<sup>336</sup>

Particularly concerned with the overcompensation that initial selling "panic" created in typical damage calculations, the Private Securities Litigation Reform Act attempted to place a limit on the damages recovered in 10(b) actions, focused on

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<sup>332</sup> One article proposes a mathematical formula to accomplish this. Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 STAN. L. REV. 7, 23 (1994) (arguing that failure to remove overreaction from damage figures ends up substantially overestimating plaintiffs' damages).

<sup>333</sup> See, e.g., *In re Cendant Corp. Litig.*, 264 F.3d 201, 234 (3<sup>rd</sup> Cir. 2001) (discussing expert witness calculation of damages in 10(b) suit); *Robbins v. Koger*, 116 F.3d 1441, 1445-1446 (11<sup>th</sup> Cir. 1997) (same).

<sup>334</sup> Robert B. Thompson, "Simplicity and Certainty" in *the Measure of Recovery Under Rule 10b-5*, 61 BUS. LAW. 1177, (August 1996) (noting that in some measures of recovery the "plaintiff bears the burden of uncertainty of how much of the change is fraud related and how much is market related and in others the risk of this uncertainty is borne by defendants," citing *Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527, 533 (10<sup>th</sup> Cir 1962)).

<sup>335</sup> WILLIAM K. S. WANG & MARC. I. STEINBERG, INSIDER TRADING § 4.8.2.2 (1996) (distinguishing "expedient" out-of-pocket measure from true out-of-pocket, which uses value of stock at time of plaintiff's transaction). See also cases cited in Thompson, *supra* note n-1 at \* n. 76.

<sup>336</sup> Professor Thompson argues in favor of the use of the expedient out-of-pocket measure, but where appropriate courts should reduce the plaintiffs' recovery by "the amount that the defendant proves was due to changes in the market," properly placing on the party who committed the fraud the uncertainty of market changes. Thompson, *supra* note n-2 at \* (near note 109) and \* (near nn26-30) (discussing ways in which various damage measures operate to allocate the risk of non-fraud related decreases in value of the stock to defendants, and noting that use of the pure, unmodified out-of-pocket measure avoids this).

preventing plaintiffs from taking advantage of market overcorrection following a corrective disclosure revealing fraud.<sup>337</sup> The relevant provision provides, *in toto*:

(e) Limitation on damages.

(1) In general. Except as provided in paragraph (2), in any private action arising under this title [15 U.S.C. §§ 78a *et seq.*] in which the plaintiff seeks to establish damages by reference to the market price of a security, the award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.

(2) Exception. In any private action arising under this title [15 U.S.C. §§ 78a *et seq.*] in which the plaintiff seeks to establish damages by reference to the market price of a security, if the plaintiff sells or repurchases the subject security prior to the expiration of the 90-day period described in paragraph (1), the plaintiff's damages shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the security and the mean trading price of the security during the period beginning immediately after dissemination of information correcting the misstatement or omission and ending on the date on which the plaintiff sells or repurchases the security.

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<sup>337</sup> Congress's Conference Report on the Private Securities Litigation Reform Act describes the measure of damages in securities fraud cases as "complex and uncertain," and assumes that the typical measure is "the difference between the price the investor paid for the security and the price of the security on the day the corrective information gets disseminated to the market" (i.e. the expedient out-of-pocket measure). H.R. CONF. REP. No. 369, 104<sup>th</sup> Cong., 1<sup>st</sup> Sess. 42 (1995) *reprinted in* 1996 U.S.C.C.A.N. 730, 741. It then discusses the need to reduce plaintiffs' recovery by losses caused by an amount representing effects of other market conditions, by using a "look back" or rebound period to calculate a "mean trading price" if the plaintiff sells or repurchases the securities during the 90-day period following the corrective disclosure. *Id.*

(3) Definition. For purposes of this subsection, the “mean trading price” of a security shall be an average of the daily trading price of that security, determined as of the close of the market each day during the 90-day period referred to in paragraph (1).

Though referred to by Congress as a “measure” of damages,<sup>338</sup> this provision does nothing more than create a potential cap,<sup>339</sup> and in fact it does not mandate that other market effects be removed from plaintiffs’ recovery. While arguably permitting defendants to benefit from any rebound in price the stock may experience after an initial crash or panic that follows corrective disclosure, it does little to clarify the measure of damages in 10(b) cases.<sup>340</sup>

None of the analyst bias cases has yet to reach the damages stage, but the measure likely to be used therein is out-of-pocket losses. This is true notwithstanding that in a declining market plaintiffs would usually opt for rescissory damages,<sup>341</sup> given that plaintiffs generally did not transact with the analyst and broker-dealer defendants,<sup>342</sup> but

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<sup>338</sup> Conference Report, *supra* note \* at 42, 1996 U.S.C.C.A.N. at 741.

<sup>339</sup> As Professor Thompson points out, the “cap” does not even accomplish its mission of excluding from plaintiff’s damages any panic effect when its provisions are applied in a declining market. *Id.* at \* page including notes 99-100.

<sup>340</sup> Thompson, *supra* note \* at pages containing notes 89-96 (my copy from L-N is not star paginated) (illustrating by way of numerical examples how PSLRA’s cap confounds effort to remove market effects from fraudulently inflated stock price).

<sup>341</sup> Thompson, *supra* note \* at text surrounding notes 26&27 (ditto re star pagination).

<sup>342</sup> Note that plaintiffs in the analyst bias cases are usually not clients of the broker-dealer defendant that employed the analyst defendant. Investors who signed brokerage agreements with arbitration clauses are limited to seeking individual redress via industry-sponsored NASD arbitration proceedings, which may be less inclined to make large awards but which, on the other hand, are not as constrained by legal technicalities. Barbara Black and Jill I. Gross, *Making It Up As They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 1006-07 (2002); *Skinner v. Donaldson, Lufkin & Jenrette Secs. Corp.* (In re Skinner), No. C 03-2625 VRW, 2003 U.S. Dist LEXIS 24045 (N.D. Cal. Dec. 29, 2003) (denying motion to vacate arbitral award in favor of broker dealer in case alleging analyst bias). *See also* Susanne Craig and John Hechinger, *Wall Street’s Dispute Process Under Fire From Regulators*, WALL ST. J. (July 20, 2004), at C1 (describing, in part, arbitration process). However, class action arbitration is prohibited by NASD arbitration rules, therefore class action plaintiffs are required by SLUSA to proceed in federal court.

instead bought shares in the open market<sup>343</sup> allegedly based on analysts' public recommendations. Depending on whether courts will use the true or the expedient out-of-pocket measure, it appears that a battle of the experts ultimately will ensue to determine what portion of the reduction in value of the stock's price.<sup>344</sup> Thus, with damages the perennial "afterthought" of class action securities litigation, this element inevitably will serve as the final fierce frontline in any case that does not settle before trial.<sup>345</sup>

### **Section VIII - Statute of Limitations**

While each of the elements of the claim is critical to analysis of the overall merits of any analyst bias suit, no discussion of analyst and broker-dealer liability would not be complete without at least a brief discussion of the relevant statute of limitations and its effect on the cases.

Claims brought under 10(b) have long carried a one year/three year statute of limitations: suit must be brought within one year after discovery of the facts giving rise to the claim, and no more than three years after the securities transaction at issue.<sup>346</sup> The Sarbanes-Oxley Act of 2002 extended the limitations period for federal securities fraud claims to the earlier of two years after the discovery of the facts constituting the violation

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<sup>343</sup> See *Green v. Occidental Petroleum*, 541 F.2d 1335, 1341 n1 (9<sup>th</sup> Cir. 1976) (Sneed, J., concurring, defining typical "open market" case as one in which defendants had no direct dealings with plaintiffs, and therefore obtained no direct pecuniary gain from plaintiff's transaction).

<sup>344</sup> See Lowenfels and Bromberg, *supra* note \*.

<sup>345</sup> See Thompson, *supra* note \* at (text accompanying notes ~7,8) (explaining that litigants are often content to "leave the measure of recovery to be resolved another day" and that few courts, given the number of cases that settle early, have been forced to define the measure of damages).

<sup>346</sup> 15 U.S.C. § 78i(e); see also *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 364 n.9 (1991) (analogizing to express one year/three year statutes of limitations elsewhere in the 1933 and 1934 Acts and holding that § 10(b) claims are subject to the limitations period set forth in § 9(e) of the Securities Exchange Act of 1934).

or five years after such a violation.<sup>347</sup> Though the legislation clearly provides that it “shall apply to all proceedings addressed by this section that are commenced on or after the date of enactment of this Act [July 30, 2002],”<sup>348</sup> and that “[n]othing in this section shall create a new, private right of action,”<sup>349</sup> what is not clear is whether Sarbanes Oxley’s limitation period was meant to revive claims that may have already expired under the preexisting one year/three years statute.

#### **(a) Existing General Precedent**

In this regard, the Circuit Courts of Appeal have consistently held that applying the longer statute of limitations to revive previously time-barred claims is impermissible unless the legislature clearly expresses the intent to do so.<sup>350</sup> Predictably, the district courts that have addressed the question relative to Sarbanes-Oxley’s new longer limitations period, in non-analyst cases, have come up with mixed results.

In *Roberts v. Dean Witter Reynolds Inc.*,<sup>351</sup> the district court found that Sarbanes-Oxley revived already time-barred claims, reasoning that the legislative history demonstrated Congress’s intention to achieve that result.<sup>352</sup> An interlocutory appeal on

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<sup>347</sup> Section 804 of the Sarbanes-Oxley Act provides:

[A] private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, as defined in section 3(a)(47) of the [Exchange Act] [15 U.S.C. § 78c(a)(47)], may be brought not later than the earlier of --

(1) 2 years after the discovery of the facts constituting the violation; or  
(2) 5 years after such violation.

28 U.S.C. § 1658.

<sup>348</sup> Sarbanes-Oxley Act § 804(b), P.L. No. 107-204, 116 Stat. 745 (2002).

<sup>349</sup> *Id.* at § 804(c).

<sup>350</sup> *Million v. Frank*, 47 F.3d 385, 390 (10th Cir. 1995); *Kan. Pub. Employees Ret. Sys. v. Reimer & Koger Assocs., Inc.*, 61 F.3d 608, 615 (8th Cir. 1995); *Chenault v. United States Postal Serv.*, 37 F.3d 535, 539 (9th Cir. 1994); *Resolution Trust Corp. v. Artley*, 28 F.3d 1099, 1103 n.6 (11th Cir. 1994); *FDIC v. Belli*, 981 F.2d 838, 842-43 (5th Cir. 1993). *See also* *Stone v. Hamilton*, 308 F.3d 751, 757 (7th Cir. 2002); *In re Apex Exp. Corp.*, 190 F.3d 624, 642 (4th Cir. 1999). The Ninth Circuit’s holding in *Chenault* was cited with approval by the U.S. Supreme Court in *Hughes Aircraft Co. v. United States, ex rel. Schumer*, 520 U.S. 939 (1997).

<sup>351</sup> No. 8:02-cv-2115-T-26EAJ, 2003 U.S. Dist. LEXIS 5676 (M.D. Fla., March 31, 2003).

<sup>352</sup> *Id.* at \*\*9-12.

the question is currently pending before the Eleventh Circuit Court of Appeals.<sup>353</sup> A similar result obtained in *In re AOL Time Warner, Inc. Sec. and "ERISA" Litig.*<sup>354</sup> The court held that the longer Sarbanes-Oxley limitations period applies to cases filed after its date.<sup>355</sup> There, the first class action complaint was filed on July 18, 2002, two weeks before Sarbanes-Oxley was enacted, and a consolidated complaint filed on September 16, 2002. Therefore, although "in most cases, class actions or otherwise, the date of the first filing is the operative one for statute of limitations purposes," the court deemed the later filing date of the consolidated complaint the operative date for purposes of limitation of this action. The court's rationale for permitting the case to proceed under the longer statutory period provided for by Sarbanes-Oxley was that any other result would be "both inequitable and impractical" in that it would unfairly punish the plaintiffs for filing too early and would lead to a mass opt-out from the class.<sup>356</sup>

Other district courts have issued opinions consistent with the presumption against retroactivity. In the case of *In re Enterprise Mortgage Acceptance Co., LLC Sec. Litig.*,<sup>357</sup> Judge Kram of the Southern District of New York held that "there is no clear language in the statute stating that it applies retroactively or that it operates to revive time-barred claims," and that the Act disavowed creation of any new rights of action, expressly disagreeing with the Roberts court's interpretation of the legislative intent.<sup>358</sup> Similarly, in *Glaser v. Enzo Biochem, Inc.*,<sup>359</sup> a Virginia district court held that "Congress did not unambiguously provide that the [new] limitations period would apply

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<sup>353</sup> *Id.* at \*\*12-13.

<sup>354</sup> MDL Docket No. 1500, 02 Civ. 5575 (SWK), 2004 U.S. Dist. LEXIS 7917 (S.D.N.Y. May 5, 2004).

<sup>355</sup> *Id.* at \*\*27-28.

<sup>356</sup> *Id.* at \*\*25-26.

<sup>357</sup> 295 F. Supp. 2d 307 (S.D.N.Y. 2003).

<sup>358</sup> *Id.* at 312.

<sup>359</sup> 303 F. Supp. 2d 724 (E.D. Va. 2003).

retroactively.”<sup>360</sup> That coupled with the presumption against retroactivity led the court to dismiss the claims as time-barred.<sup>361</sup> Other jurisdictions have agreed.<sup>362</sup>

### **(b) Pending Analyst Liability Cases**

In one of the *Worldcom*-related cases<sup>363</sup> Judge Cote found that “there is no explicit language in the statute” that would operate to revive time-barred claims. She also felt that lengthening the statute of limitations this way “would affect the substantive rights of the defendants by depriving them of a defense on which they were entitled to rely.” Accordingly, she held that “Sarbanes Oxley does not revive previously time-barred private securities fraud claims” and dismissed those claims in the case that had expired in June 2002 (a month before Sarbanes-Oxley was passed).<sup>364</sup>

The question of which limitations period to apply is not at issue in some of the analyst bias cases.<sup>365</sup> Nonetheless, a relevant issue has been at what point in time plaintiffs were on notice of their claims, so as to trigger the running of the relevant limitations period. Circuit Courts generally have applied some version of the constructive or inquiry notice doctrine in 10b cases, such that the statute begins to run

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<sup>360</sup> *Id.* at 734.

<sup>361</sup> *Id.*

<sup>362</sup> *See* *In re Heritage Bond Litigation*, 289 F. Supp. 2d 1132 (C.D. Cal. 2003). There, plaintiffs first asserted their Section 20(a) claims based on statements made more than three years earlier in a complaint filed on July 24, 2002, just days before the passage of Sarbanes-Oxley. They then filed another complaint asserting the same claims on August 30, 2002. The court held that “while the amended statute of limitations may apply to proceedings filed after passage of the Act, it cannot apply to claims already barred at the time of its enactment, regardless of the filing date.” *See also* *Lieberman v. Cambridge Partners, L.L.C.*, No. Civ. A. 03-2317, 2004 U.S. Dist. LEXIS 11553, at \*3 and n.12 (E.D. Pa. June 21, 2004); *In re Enron Corp. Sec., Derivative & Erisa Litig.*, No. MDL-1446, Civ.A. H-01-3624, 2004 U.S. Dist. LEXIS 8158, at \*17 (S.D. Tex. Feb. 25, 2004).

<sup>363</sup> *In re WorldCom, Inc. Sec. Litig. (re TARGETS)*, Nos. 02 Civ. 3288 and 03 Civ. 9490 (DLC), 2004 U.S. Dist. LEXIS 11696 (S.D.N.Y. June 28, 2004).

<sup>364</sup> *Id.* at \*\*23-24. In a different proceeding related to Worldcom, Judge Cote also found that the new longer limitations period of Sarbanes-Oxley did not apply to Section 11 and Section 12(a) claims brought under the Securities Act of 1933. *In re WorldCom (re State of Alaska Dept. of Rev.)*, 294 F. Supp. 431, 440-441 (S.D.N.Y. 2003).

<sup>365</sup> *See, e.g., Pfeiffer v. Goldman Sachs & Co.*, No. 02 Civ. 6912 (HB), 2003 U.S. Dist. LEXIS 11120 (S.D.N.Y., June 30, 2003) (applying one year/three year statute to suit filed in August 2002 without discussion).



when the plaintiff has actual knowledge of the facts giving rise to his claims or has notice of facts that in the exercise of reasonable diligence should have led to such knowledge.<sup>366</sup>

In this regard, plaintiffs appear to have been in something of a bind – pointing to in-depth journalists’ accounts of analyst bias in support of their claims, but stuck with the fact that some of that media coverage well predated the filing of their complaints, and pointing to analysts’ steadfast refusal to downgrade despite plummeting share prices as early as 2000 as facts supporting falsity and scienter, but not having filed their suits until well after that. The district courts have come down both ways, some holding that a steep decline in share price or popular press coverage should have put plaintiffs on notice of the purported fraud, and others going so far as to say that while loss causation may have been known at that point, facts supporting the element of scienter were not known until the results of governmental or regulatory investigations, including internal email messages, were made public.<sup>367</sup>

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<sup>366</sup> See, e.g., *LC Capital Partners, LP v. Frontier Ins. Group, Inc.*, 318 F.3d 148, 154 (2d Cir. 2003); *In re NAHC, Inc. Sec. Litig.*, 306 F.3d 1314, 1325-27 (3d Cir. 2002); *Young v. Lepone*, 305 F.3d 1, 8 (1st Cir. 2002); *Franze v. Equitable Assurance*, 296 F.3d 1250, 1254 (11th Cir. 2002) (“Inquiry notice is triggered by evidence of the possibility of fraud, not full exposition of the scam itself.”); *Ritchey v. Horner*, 244 F.3d 635, 638-39 (8th Cir. 2001); *Sterlin v. Biomune Sys.*, 154 F.3d 1191, 1201 (10th Cir. 1998) (“Inquiry notice ... triggers an investor's duty to exercise reasonable diligence, and ... the one-year statute of limitations period begins to run once the investor, in the exercise of reasonable diligence, should have discovered the facts underlying the alleged fraud.”); *Marks v. CDW Computer Centers, Inc.*, 122 F.3d 363, 367 (7th Cir. 1997) (“Not only must the investor be on notice of the need to conduct further inquiry, but the investor also must be able to learn the facts underlying the claim with the exercise of reasonable diligence.”); *Ockerman v. May Zima & Co.*, 27 F.3d 1151, 1155 (6th Cir. 1994).

<sup>367</sup> See, e.g., *In re Merrill Lynch Research Reports Sec. Litig.*, 273 F. Sup. 2d 351, 378-382 (S.D.N.Y. 2003) (finding investors were put on inquiry notice of the fraud by specific media coverage exposing key elements of the plaintiffs’ claims and by defendants’ continued issuance of “buy” ratings despite substantial declines in the trading price of the stocks); *In re Merrill Lynch Research Reports Sec. Litig.*, 289 F. Sup. 2d 429 (S.D.N.Y. 2003) (same); *Pfeiffer v. Goldman, Sachs & Co.*, No. 02Civ. 2912 (HB), 2003 U.S. Dist. LEXIS 11120, \*14 (S.D.N.Y. June 30, 2003) (finding that lead plaintiff was on notice of facts constituting fraud as of date fourteen months before filing this suit, when he filed a substantially similar suit against some of the same defendants in state court); *DeMarco v. Lehman Bros.*, 309 F. Supp. 2d 631, 637 (S.D.N.Y. 2003) (holding that though element of loss causation may have been known by plaintiffs as early

In the only appellate decision on the topic, the Eleventh Circuit Court of Appeals has refused to hold as a matter of law that a steep decline in the price of the relevant stock put plaintiffs on inquiry notice so as to trigger the statute of limitations. In *LaGrasta v. First Union National Bank*,<sup>368</sup> the appellate court reversed the district court's dismissal of the suit as time-barred. In so doing, it noted there were numerous factual questions remaining to be answered before inquiry notice could be triggered on any date prior to June 2000, when a First Union analyst admitted her conflict of interest with respect to Ask Jeeves stock coverage in a Smart Money magazine article.<sup>369</sup> As the suit had been filed in March 2001, it was permitted to proceed, at least until discovery might reveal better defense arguments on this point.<sup>370</sup>

The statute of limitations inquiry is necessarily a highly fact intensive question. Some guidance from the Eleventh Circuit will be helpful as to which statute applies, but the necessary definitive – for most analyst bias cases – word from the Second Circuit is as yet forthcoming.

## **Section IX – Conclusions**

Indeed it is true that no easy or general conclusion can be drawn about whether so-called “analyst bias” gives rise to 10(b) liability. The pending analyst bias suits vary as to the form their allegations have taken, and each case necessarily involves an *ad hoc* examination of its unique facts. While some seem to fit the 10b pattern quite easily, others raise interesting new questions of securities law and federal class action procedure.

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as 2000, but the element of scienter was not known until the intentional lie in the reports was revealed by the bad emails.

<sup>368</sup> 358 F.3d 840 (11<sup>th</sup> Cir. 2004).

<sup>369</sup> *Id.* at 848.

<sup>370</sup> *Id.* at 851.

What does appear to be clear is that allegedly tainted stock recommendations qualify as either material misrepresentations or omissions of material fact made in connection with a purchase or sale of securities. Likewise, the scienter element likely will not pose a significant problem in those cases where there is either direct or circumstantial proof of an analyst's opinion not being genuinely, where the relationship between analyst and issuer is quite tangled, or where there is some evidence of a quid pro quo arrangement between broker-dealer or analyst and the securities issuer of positive ratings for profitable investment banking business.

The biggest battles in this most recent securities law skirmish will be on the subjects of reliance and loss causation. Individual reliance is generally not the case here, therefore analyst bias plaintiffs are depending on one or both available reliance presumptions. While there is little question that the *Affiliated Ute* presumption applies where material omissions are alleged, the question of the fraud-on-the-market presumption's applicability in those cases framed as material misrepresentations is thornier. Existing precedent and the overall purpose and remedial function of the federal securities laws seems to favor application of the presumption to plaintiffs affected by analysts' artificial price inflation, where a prima facie case can be shown that the analysts' recommendations moved the market for the relevant security.

Likewise, loss causation presents a novel question in this context, and especially given the Second Circuit's checkered history with this element. However, it looks as if that issue will also be resolved correctly by most courts in favor of permitting a jury to consider plaintiffs' loss causation arguments. Indeed, it will be the jury's province then to determine what damages were in fact caused by any artificial price inflation caused by

analysts' optimistic recommendations, and to separate from that what might have been an overall market effect in any given case. This, of course, will be a highly fact dependent inquiry.

When the millennium bubble burst, it generated new questions under 10b and created new interest in an important subset of securities fraud law – that involving non-issuer communications with the investing public. The congressional and regulatory reactions were almost immediate, hurriedly condemning research practices and somewhat vainly declaring the “dawn of a new day” on Wall Street. But the litigation of private actions alleging analyst and broker-dealer liability arising from biased stock research and recommendations will linger a bit longer. It is from the jury verdicts and appellate opinions in these cases that we will answer the ultimate question – whether analysts in fact created or fueled the disastrous bubble and whether they should be responsible to investors. More importantly, in this process we will see yet another significant refinement of 10b jurisprudence.